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OPEN MARKET MANIPULATION: THE DANGERS OF POLICING THOUGHT

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I. INTRODUCTION[1]

U.S. federal agencies, including the Securities Exchange Commission, the Commodity Futures Trading Commission, the Federal Energy Regulatory Commission and the Federal Trade Commission, have a broad array of tools available to them to prosecute alleged manipulation in the securities, physical commodity and derivatives markets. Perhaps the most potent of those tools are statutory and regulatory provisions that prohibit fraud-based market manipulation. All of the fraud-based anti-manipulation statutes make it unlawful to "use or employ [in connection with a jurisdictional transaction] any manipulative or deceptive device or contrivance" in connection with a transaction subject to the jurisdiction of the agency.[2]

The agencies drafted their rules prohibiting fraud-based manipulation in ways that depart from the underlying statutory prohibition of manipulative and deceptive conduct.[3] The agencies' rules are broader in some respects (they refer to practices beyond those listed in the statutes) and narrower in other respects (three of four do not prohibit the use of "manipulative" devices). The anti-manipulation rules generally make it unlawful to "use or employ" "any device, scheme or artifice to defraud," "make" materially untrue statements (or omissions), or "engage" in any act or practice that operates or would operate as a fraud. Only the CFTC's rule expressly prohibits the use or employment of a "manipulative" device, scheme or artifice to defraud.[4]

Despite the broad phrasing of the agency rules, Congress only prohibited conduct that is: (1) manipulative or (2) deceptive.[5] Nevertheless, federal agencies often bring cases alleging that open market transactions violate the Anti-Manipulation Laws based solely upon allegations of *intent* to engage in manipulative or deceptive conduct. They argue that undisclosed intent to accomplish a goal other than profit constitutes a fraud or deceit of the market because the open market bid or offer communicates false information to the market concerning the "real" purpose of the bid or offer. Channeling their inner Hamlet, the regulators' view seems to be: "for there is nothing either good or bad, but thinking makes it so."[6] Federal agencies often argue that it is irrelevant whether the open market transaction involved an overt deceptive act, was consistent with supply and de-

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mand fundamentals, contributed to the formation of a market-based price, created an artificial price or harmed the market, presumably by creating an artificial price.

It is understandable why federal regulators have concerns about transactions that they believe are motivated by an improper purpose. It also is understandable why they would prefer to eliminate the conduct element from an Anti-Manipulation Law violation and rely exclusively on intent. Proving manipulative or deceptive conduct is more difficult than inferring improper intent based upon communications that may be subject to multiple interpretations. The same is true with respect to transactions that appear, with the benefit of hindsight, to be uneconomic or to form an unusual pattern. It also is easier to state a claim for a violation that will not be dismissed if all that must be alleged is wrongful intent. But claiming that a trade is unlawful solely because of a trader's alleged intent exceeds the agencies' statutory authority. Congress did not mandate the regulators to be Thought Police.[7] According to the plain language of the statutes and Supreme Court precedent, each regulator's mandate is limited to policing deceptive or manipulative *conduct*.

The Anti-Manipulation Laws require proof of every element of a violation, including deceptive or manipulative *conduct*, even in the context of alleged open market manipulation. Requiring proof of deceptive or manipulative conduct is important because open market bids and offers do not by themselves communicate false information to the market. In addition, they typically do not create an artificial price. They simply announce that a market participant is willing to buy or sell a specified quantity of a product at a specified price—full stop. There is no cogent or objective basis for distinguishing between lawful and unlawful open market bids or offers based solely upon a trader's alleged secret intent to defraud or manipulate. An open market bid or offer can only make a misrepresentation to the market that constitutes a fraud or deceit if it creates an artificial price that misrepresents the value of the underlying product. If an open market transaction is consistent with supply and demand fundamentals, it cannot be manipulative or harm the market.

There are a number of ways in which regulators might legitimately allege and prove the use or employment of a manipulative or deceptive device or contrivance in the context of open market transactions. A market participant may have communicated false information to the market in connection with, or separately from, submitting open market bids or offers in order to mislead other market participants. That would be intentionally deceptive conduct. Alternatively, a market participant may have engaged in a pattern of trading where the conduct—the trading pattern, even if lawfully executed in the open market—created an artificial price. For example, a market participant might flood the market with a huge volume of large orders during the period in which the closing price is determined, often referred to as "banging the close." Market participants might even collude to control price. All these scenarios are examples of potentially manipulative conduct. But the conduct is not manipulative because of the trader's intent. The conduct is manipulative because it controlled price or created an artificial price.

In this article, we explain that Supreme Court precedent requires that in cases involving open market transactions regulators must allege and

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prove actual control of price or creation of an artificial price in order to establish an Anti-Manipulation Law violation. Absent price control or artificiality, open market trades, even paired with wrongful intent, can never by themselves constitute *deceptive conduct*. Open market trades do not, in themselves, make a material misrepresentation or omit material facts about which there is a duty to speak. Consequently, the regulator must allege and prove *manipulative conduct*, which the Supreme Court has held is conduct that controls or artificially affects a market price for the purpose of deceiving or defrauding market participants.[8] Unlike an open market bid or offer, an artificial price misrepresents to market participants the true supply of and demand for a commodity or other product subject to Anti-Manipulation Laws.

Proper application of Supreme Court precedent leads to several key principles about open market fraud-based manipulation claims:

- *Conduct*, separate and apart from intent, must be manipulative or deceptive to violate the Anti-Manipulation Laws;
- Open market transactions cannot, in themselves, constitute a *deceptive* device or contrivance because they do not communicate a misrepresentation or omit to state a material fact for which there is a duty to speak;
- Open market transactions *can* be part of *manipulative* devices or contrivances, but only if they control price or create an artificial price;
- Because open market trades can only violate an Anti-Manipulation Law if they control or create an artificial price, alleging and demonstrating control of price or creation of an artificial price is an essential element of an open market manipulation claim; and
- An open market transaction that "takes" the market price is not deceptive and cannot control price or create an *artificial* price and, therefore, cannot violate the Anti-Manipulation Laws.

In the current regulatory environment, compliance and legal personnel providing advice to business personnel about a proposed transaction must imagine what a regulator might, with the benefit of hindsight, perceive or infer about the intent of the transaction. The most that compliance and legal personnel can do now to mitigate regulatory risk is to document in advance the purpose behind a transaction and hope that regulators will not second-guess the analysis.[9]

Requiring agencies to allege and prove manipulative or deceptive conduct in the context of open market manipulation cases would yield many positive benefits and have no meaningful downside. Congress' will would be effectuated and agencies would be able to effectively police wrongful conduct. Agencies would no longer be able to act as the Thought Police and bring allegations based on intent alone. Attorneys and compliance personnel would be able to provide reasonable guidance to businesses based upon objective criteria. If an open market trade could control price or cause the creation of an artificial price, they would know the risks of acting. This is a practical and objective standard.

II. WHAT IS AN OPEN MARKET?

A. THE CHARACTERISTICS OF AN OPEN MARKET

There probably is no such thing as a truly open market in which market participants can trade freely without limits and where prices are determined exclusively by the intersection of supply and demand. Almost all organized markets impose some limits on prices in the form of a cap, a floor, or an intraday price range. Many organized markets also place limits on the size of positions that any one trader or aggregated group can hold in a particular contract. For purposes of this article, we consider an open market to be one in which a market participant or a market operator can lift any offer or hit any bid made by another market participant consistent with the order type and placement rules of the relevant market.

There are many types of orders to execute transactions that can be submitted in various markets. Order types define and communicate the parameters under which a market participant is prepared to transact. For purposes of this article, we focus primarily on orders (bids and offers) in the organized wholesale power markets, the futures markets and the securities markets.

1. THE ORGANIZED WHOLESALE POWER MARKETS

In the organized wholesale power markets, bids to buy and offers to sell electric energy are made in day-ahead and real-time markets. Orders may take a variety of forms that vary across the geographic markets, but a key distinction for purposes of this article is between orders that might affect the market price of electricity and orders that, by definition, do not. A price-sensitive order is an order to purchase or sell electricity up to or down to a specified price. A price-taker order, in contrast, is an order by "an individual or company that must accept prevailing prices in a market, lacking the market share to influence market price on its own."[10]

2. THE FUTURES MARKETS

The CFTC defines a "market order" as "[a]n order to buy or sell a futures contract at whatever price is obtainable at the time it is entered in the . . . trading platform."[11] Similarly, the CME defines a "market order" as "[a]n order with instructions to be executed . . . at the best available price."[12] A limit order, on the other hand, is"[a]n order in which the customer specifies a minimum sale price or maximum purchase price."[13] The CME, for example, defines a "limit order" as "[a]n order with instructions to be executed at a specific price ('limit price') or better."[14] More precisely, a limit order "allows the buyer to define the maximum price to pay and the seller the minimum price to accept (the limit price)."[15]

3. THE SECURITIES MARKETS

The SEC defines a "market order" as "an order to buy or sell a security immediately. This type of order guarantees that the order will be executed, but does not guarantee the execution price. A market order generally will execute at or near the current bid (for a sell order) or ask (for a buy order) price." The SEC defines a "limit order" as "an order to buy or sell a security at a specific price or better. A buy limit order can only be executed at the limit price or lower, and a sell limit order can only be executed at the limit price or higher."[16]

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B. INFORMATION THAT OPEN MARKET BIDS, OFFERS AND TRANSACTIONS DO AND DO NOT COMMUNICATE

Various types of orders, including those described above, define the scope of the information that they communicate to other market participants or the relevant market operator. Open market orders communicate a single transparent and objective piece of information: the willingness of a market participant to buy or sell a specified quantity of a product at a defined price. They communicate no information at all about the market participant's intent or strategy in placing the order. Because open market orders communicate no information about intent or strategy, they cannot misrepresent a trader's intent or strategy and they create no duty to disclose omitted information to correct a misrepresentation.[17]

Open market bids and offers aid the price-discovery function of organized markets. The prices resulting from open market transactions depend, in part, on the order type, execution time, market liquidity and supply and demand fundamentals. A price-taker or market bid or offer only executes if there is a willing buyer or seller on the other side of the trade. A price-taker order generally should have no impact on price, certainly no artificial impact, because, by definition, the trader agrees to "take" the then-current market price, whatever it may be. A large volume of market orders during the closing or price-determination period might place pressure on prices, particularly if liquidity is low. However, as long as the resulting price reflects supply and demand for the product, it is not artificial. Because a price-taker bid or offer, by definition, only can execute at the market price, the trade reflects true information about supply and demand.

The information that open market bids, offers and transactions *do not* communicate to the market is equally important. If the person who submits the order is willing to transact on the terms submitted, the order cannot communicate anything fraudulent or misleading to market participants because nothing else is communicated by the order. Whether open market transactions might be manipulative or deceptive does not turn on the undisclosed *purpose* of the underlying bid, offer, or resulting transaction. Instead, what the market sees is the price that results from the transaction. If the price is not artificial, the market receives no inaccurate information.

III. FRAUD-BASED ANTI-MANIPULATION RULES

The text of the fraud-based anti-manipulation rules of the federal agencies charged with policing the commodities and securities markets is similar, but differs in certain material respects.

A. FERC RULES 1c.1 AND 1c.2

FERC's anti-manipulation rule implements section 222 of the Federal Power Act. Congress modeled FPA section 222 on the anti-manipulation provision in section 10(b) of the SEA. The FPA anti-manipulation provision makes it unlawful to "use or employ . . . any manipulative or deceptive device or contrivance (as those terms are used in section 78j(b) of title 15 [section 10(b) of the SEA])."

FERC's anti-manipulation rule does not parrot the language of the FPA. FERC modeled its anti-manipulation rule on the language of SEC Rule

10b-5. Both rules prohibit three categories of conduct in connection with a jurisdictional transaction: (1) the use or employ of any device, scheme, or artifice to defraud; (2) making untrue statements and omissions of material fact; and (3) engaging in any act, practice or course of business that operates or would operate as a fraud or deceit upon any entity.

B. SEC RULE 10b-5

SEC Rule 10b-5 and SEA section 10(b) are substantively identical to the FERC anti-manipulation rule and FPA section 222, except for the jurisdictional element. SEA section 10(b) makes it unlawful to "use or employ . . . any manipulative or deceptive device or contrivance."[18] Like the FERC's anti-manipulation rule for which it served as a model, and unlike the CFTC's anti-manipulation rule, SEC Rule 10b-5 does not refer to manipulative devices.[19]

C. CFTC RULE 180.1

CEA Section 6(c)(1), like its counterparts in the SEA and the FPA, makes it unlawful, in connection with a CFTC-jurisdictional transaction, to "use or employ . . . any manipulative or deceptive device or contrivance" in contravention of rules promulgated by the CFTC. CFTC Rule 180.1(a), which implements the manipulation prohibition in CEA Section 6(c)(1), prohibits the same three types of fraudulent conduct as the SEC's and the FERC's anti-manipulation rules, plus making false or misleading reports of market information. However, unlike the SEC's and the FERC's anti-manipulation rules, the CFTC's rule expressly prohibits the use or employment of manipulative devices. In another important departure from the SEC's and FERC's rules, CFTC Rule 180.1 provides that it does not "require any person to disclose to another person nonpublic information that may be material to the market price, rate, or level of the commodity transaction, except as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect."[20]

Unlike the SEC's and the FERC's rules, CFTC Rule 180.1 expressly applies to attempted violations and explicitly references the applicable intent element ("intentionally or recklessly") of a violation. Proof of unlawful intent is not enough to establish an attempt violation under CFTC Rule 180.1. To prove an attempt violation, the CFTC must prove that the defendant intended to create a price that does not reflect supply and demand, and committed an overt act in furtherance of that intent.[21] Putting aside the question of whether CEA Section 6(c)(1) prohibits attempted fraud-based manipulation, and assuming that the CFTC can prove the intent element of a violation, the required overt act must be deceptive or manipulative.

D. COMMON ELEMENTS SHARED BY ALL FRAUD-BASED ANTI-MANIPULATION RULES

Each agency's rule understandably focuses on the breadth of its authority to pursue "fraud" and deceit. However, each rule is subject to the limitations of the statute that it implements. Each of the statutory anti-fraud provisions in the CEA, FPA and the EISA is modeled on section 10(b) of the Exchange Act. Like section 10(b), each statutory provision prohibits, in connection with the various jurisdictions, the "use or employ . . . [of]

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any manipulative or deceptive device or contrivance."[22] Regardless of the phrasing of their various rules, no agency may prosecute conduct that does not fall within the statutory prohibition against conduct that is "manipulative" or "deceptive."

IV. OPEN MARKET MANIPULATION POSITIONS ASSERTED BY REGULATORS

A. THE FERC

Side-stepping the statutory requirement to prove either manipulative or deceptive conduct, FERC has explained that its rule broadly prohibits "fraud."[23] Fraud, according to FERC, is a question of fact and is defined generally "to include any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market."[24] FERC asserts that well-functioning markets are not necessarily markets where the products traded reflect the fundamentals of supply and demand. Rather, FERC's position is that a well-functioning market is a market that functions however FERC says it should function, even if it leads to artificial prices.[25]

FERC argues that its definition of "fraud includes open-market transactions executed with manipulative intent."[26] FERC also claims that it is not required to allege or prove an artificial price.[27] Nor, according to FERC, must it allege or prove harm because its anti-manipulation rule contemplates violations based on "attempted fraud."[28] Thus, in FERC's view, "the difference between legitimate open-market transactions and illegal open market transactions may be nothing more than a trader's manipulative purpose for executing such transactions."[29]

B. THE CFTC

The CFTC has charged companies with manipulating commodity interest prices through open market transactions under both its fraud-based and its artificial price anti-manipulation authority. *CFTC v. Wilson* is an example of a case in which the CFTC alleged that open market orders manipulated futures contract prices based upon intent alone. Although *Wilson* did not involve the CFTC's fraud-based anti-manipulation rule, the CFTC's open market allegations were similar to those made by other agencies which claim that intent alone can transform otherwise lawful bidding activity into unlawful conduct.

The rules of the applicable exchange provided that the settlement price of the relevant interest rate swap futures contract was determined "by taking into account different variables, including [unexecuted] bids and offers placed during fifteen-minute settlement windows."[30] The CFTC charged that Wilson and DRW Investments, LLC manipulated futures prices by placing bids during the settlement window with the intent to affect the settlement price for the purpose of benefitting other open positions. As described by the court, the CFTC asserted that "*intent is the transformative element for market manipulation* and that artificial price [can] be proven merely by showing that Defendants intended to affect the settlement price by making electronic bids during the [2:45 to 3:00 p.m.] Settlement Period."[31] The CFTC also argued that bids placed with the intent to affect the settlement price and, thereby, benefit other open positions, "were *inherently manipulative* regardless of whether they were reflective of fair market value. . . ."[32] The court rejected the CFTC's theory as having "no basis in law or logic."[33]

In *CFTC v. Kraft et al*., the CFTC charged Kraft with violating its fraud-based manipulation provision through open market transactions, but not based solely on unlawful intent.[34] In ruling on Kraft's motion to dismiss, the court held that the CFTC had stated a claim for a violation of its fraud-based anti-manipulation provision by alleging that: "(1) Kraft *took a huge wheat futures position*; (2) that it did not intend to use in production; (3) but instead *intended* that the position would signal Kraft's demand for wheat in the relevant time period; (4) in a way that would mislead others in the market into thinking that Kraft would take delivery of its futures position and not buy cash wheat; (5) which was *intended* to, and in fact did, cause cash wheat prices to decrease and the price for futures to increase."[35]

The court summarized the complaint as alleging that "Kraft sought [through open market transactions] to create the false appearance of demand for wheat from the December 2011 futures contract. Kraft had no intention to use the wheat from its huge futures position. Thus, Kraft, through its activities in the market, conveyed a false sense of demand, and the resulting prices in the market (both of cash wheat and of wheat futures) were based not solely on the actual supply and demand in the market, but rather were influenced by Kraft's false signals of demand."[36] As of the time of this article, the court has not ruled on the merits of the CFTC's claims.

C. THE SEC

In *Markowski v. SEC*, the SEC took the position that intent alone is sufficient to convert a lawful open market transaction into a violation of Rule 10b-5 and section 10(b) of the SEA.[37] The D.C. Circuit reviewed Markowski's appeal of a determination by the National Association of Securities Dealers, affirmed by the SEC, that Markowski violated Rule 10b-5. Markowski's company, Global, underwrote the IPO of Mountaintop Corporation ("Mountaintop"). The court reviewed the SEC's determination that, from the IPO in June 1990 until Global's closing in January 1991, Global artificially supported the price of Mountaintop securities through a scheme executed in the open market. The SEC found that Global did so by submitting consistently high bid prices and purchasing unwanted securities, thereby artificially supporting the stock price.[38] The SEC concluded that Global's activity, even though it was effectuated through open market transactions, violated SEC Rule 10b-5.[39] Deferring to the SEC, the court held, incorrectly in our view, that it could not find that the SEC's position was unreasonable.[40]

In *SEC v. Masri*, the SEC alleged that Moises Saba Masri ("Masri") and Albert Meyer Sutton ("Sutton") violated Section 10(b) of the Exchange Act and Rule 10b-5 by manipulating the closing price of a security, T.V. Azteca S.A. de C.V. American Depositary Receipts ("TZA"), on August 20, 1999. The SEC alleged that the defendants purchased in the open market 200,000 TZA shares on August 20, 1999, in order to push the price of TZA above $5 to the benefit of a related put option position. If the price did not exceed $5 on August 20, 1999, Masri would have had to purchase 860,000 TZA shares. If the price exceeded $5, Masri would avoid having to purchase 860,000 shares at $5 per share.

After discovery, facts supporting the SEC's allegations of manipulative conduct failed to materialize.[41] The parties' dispute distilled to whether Masri had a proper or improper purpose

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for his open market trades.[42] The SEC took the position that the court could find a violation based upon improper purpose alone. Masri argued that regardless of intent, an open-market transaction unaccompanied by other deceptive or fraudulent conduct cannot, as a matter of law, support a finding of market manipulation under Section 10(b) of the SEA.[43] The court accepted, again incorrectly in our view, the flawed premise that intent alone is sufficient to find liability and split the baby, holding that to establish a violation based purely on intent requires proof that "but for the manipulative intent, the defendant would not have conducted the transaction."[44]

V. FAILURE TO FOLLOW SUPREME COURT PRECEDENT HAS LED TO CONFUSION OVER WHETHER OPEN MARKET TRADES CAN VIOLATE THE ANTI-MANIPULATION LAWS BASED SOLELY ON INTENT

Courts disagree about whether intent alone is sufficient to state a claim and find liability for market manipulation in the context of open market transactions. The differing viewpoints appear to come from a fundamental misunderstanding of open market transactions and a failure to apply controlling Supreme Court interpretations of SEA section 10(b) in open market cases. The plain terms of the SEA and the other anti-fraud provisions prohibit *conduct*—the "use or employ" of "any manipulative or deceptive device or contrivance"—not just thought.

The Supreme Court has held repeatedly that conduct—separate from, and in addition to, intent—is an indispensable element of a violation of section 10(b). In *Santa Fe Industries v. Green*, the Supreme Court explained that:

> The language of § 10(b) gives no indication that Congress meant to prohibit any *conduct* not involving manipulation or deception . . . Thus the claim . . . in this complaint states a cause of action under any part of Rule 10b-5 only if the *conduct* alleged can be fairly viewed as "manipulative or deceptive" within the meaning of the statute.[45]

The Supreme Court has defined the meaning of deceptive and manipulative conduct under section 10(b) of the Exchange Act and, by extension, the provisions that the FERC, CFTC and FTC modeled after it. Deception, and deceptive conduct, involve an affirmative "misrepresentation" or an omission (when there is a "duty to speak") "made for the purpose of inducing reliance" by other market participants.[46] Manipulation, on the other hand, is "virtually a term of art . . . [and] refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors *by artificially affecting market activity*."[47] The Supreme Court has explained that, in other words, manipulative conduct is conduct that "control[s] or artificially affect[s] the price of securities."[48]

Manipulative and deceptive conduct both sound in fraud because each involves an aspect of deception. The proposition that deceptive conduct involves deception is straightforward. It may be less obvious, however, that even manipulative conduct requires misrepresentation, but that is what the Supreme Court has said.

The Supreme Court in *Schreiber v. Burlington Northern* explained that manipulative conduct "connotes intentional or willful conduct *designed to deceive or defraud* investors by controlling or

artificially affecting the price of securities."[49] The Court observed that "Congress used the phrase 'manipulative or deceptive' in § 10(b) . . . and we have interpreted 'manipulative' in that context to require misrepresentation."[50]

The misrepresentation happens in different ways under the two types of conduct. In a claim based on deceptive conduct, the material misrepresentation or omission (where there was a duty to speak) is the deceit. In a claim based on manipulative conduct, by contrast, the misrepresentation comes from "controlling or artificially affecting" price.[51] As the Second Circuit has observed applying the Supreme Court's precedents, "[t]he gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators."[52] Similarly, Judge Posner explained in *Sullivan*, that to establish liability based upon an open market transaction, the defendant's conduct must be "manipulative in the sense—the only possibly relevant legal sense—of *bringing about* artificial prices," meaning "prices that do not reflect the underlying conditions of supply and demand."[53]

The Third Circuit held in *GFL Advantage Fund v. Colkitt* that even in the context of open market transactions, a required element of a section 10(b) violation is that "the alleged manipulator injected inaccurate information into the market or created a false impression of market activity."[54] The holding in *GFL* appears to be generally consistent with Supreme Court precedent and the SEA requirement that the government allege and prove deceptive or manipulative conduct. Injecting inaccurate information into the market constitutes deception and creating the false impression of market activity misrepresents the underlying conditions of supply and demand.

Yet, regulators take the position, and a handful of primarily district courts have incorrectly decided, that *GFL* is somehow radical. They take the incredible position in light of the statutes' and the Court's requirement of manipulative or deceptive *conduct* that intent alone is sufficient in the context of open market manipulation cases to state a claim and find a violation. They mischaracterize the holding in *GFL* as requiring something "additional" that is not required by the statute or precedent.[55] The truth, however, is exactly the opposite: *GFL* did not conclude that any additional element is required. Instead, *GFL* concluded that fraudulent conduct that could be considered manipulative or deceptive is required—*i.e.*, "that the alleged manipulator injected inaccurate information into the market or created a false impression of market activity."[56]

Furthermore, the regulators' reliance on the D.C. Circuit's decision in *Markowski* to support their allegations of Anti-Manipulation Law violations based on intent alone is misplaced. *Markowski* was wrongly decided for at least three reasons. First, courts should not defer to agencies on purely legal interpretations of the scope of conduct that Congress prohibited under the Anti-Manipulation Laws. That type of pure legal question is the province of courts. An agency's technical subject matter expertise gives it no relevant advantage to justify deference on legal questions. Second, the Supreme Court requires proof of deceptive or manipulative *conduct* to establish a violation.[57] Third, the court's reasoning is unsound. The court concluded that it was not unreasonable for the SEC to determine that purpose alone, regardless of deceptive or manipulative

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conduct, is sufficient to establish a violation of SEA section 10(b). Why? Because SEA section 9 supposedly "manifests" the idea that purpose alone is sufficient. The problem is that SEA sections 9 and 10(b) by their plain terms both require deceptive or manipulative conduct. As we have explained, SEA section 10(b) prohibits the "use or employ . . . [of] any manipulative or deceptive device or contrivance." SEA section 9 prohibits engaging in a "series of transactions . . . creating actual or apparent active trading [deceptive conduct] . . . or raising or depressing the price of such security [manipulative conduct], for the purpose of inducing the purchase or sale of such security by others [fraudulent intent]."[58] Congress did not prohibit thought violations in SEA section 10(b), and it did not do so in section 9 either.

VI. PROPER APPLICATION OF SUPREME COURT PRECEDENT TO OPEN MARKET CASES WOULD ELIMINATE THE CONFUSION CREATED BY LOWER COURT DECISIONS AND AGENCY ACTIONS

Contrary to the position taken by regulators, it is not possible to distinguish between lawful and unlawful open market bids and offers based upon the intent of the person submitting the order. Absent an affirmative misrepresentation or an omission when there is a duty to speak, an open market order communicates nothing more than the parameters, including the price, on which the trader is willing to transact. Attempting to prosecute open market transactions based upon the uncommunicated intent of the trader placing a bid or offer will chill legitimate market activity by traders who fear the absence of objective standards against which their conduct will be measured. Fewer bids and offers means less liquidity and, therefore, higher transaction costs for market participants.

The answer to avoiding regulatory overreach and chilling legitimate trading behavior requires nothing more than properly applying existing Supreme Court precedent. If regulators did so, they would not attempt to prosecute open market transactions unless a trader engaged in conduct that either: (1) constitutes a material misrepresentation or omission, in connection with the open market transaction (deceptive conduct); or (2) controls price or creates an artificial price that does not reflect the legitimate forces of supply and demand (manipulative conduct).

These standards are rooted in long-established Supreme Court precedent. The conduct that regulators have sought to prosecute in many cases might still be unlawful if the Supreme Court's legal framework were properly applied. Artificially propping up the value of a security, like the conduct alleged in *Markowski*, would still be unlawful—but not because of intent alone. Artificially moving market prices above the level reflected by supply and demand to protect a related position, as alleged in *Masri*, would still be unlawful—but not because of intent alone. Related position schemes that involve trading physical electricity at a loss to raise or lower an index artificially in order to benefit a related financial position would still be unlawful. Collusion to control price would still be unlawful. In each of these scenarios, the open market trades might constitute manipulative conduct if the trades were designed to deceive or defraud other market participants by distorting supply and demand or controlling price.

It might be more difficult in certain cases for agencies to prove a violation if the proper standard were applied. The regulator would have to allege and prove manipulative conduct that controlled price or created an artificial price. But there is no policy justification for making it easier to prove something as serious as market manipulation. The relative difficulty of proving a violation is not an appropriate consideration for agencies or courts. Congress has prohibited in the Anti-Manipulation Laws the "use or employ . . . [of] any manipulative or deceptive device or contrivance"—*i.e.*, manipulative and deceptive *conduct*, not thoughts that agencies may dislike.

VII. CONCLUSION

Correct application of the Supreme Court's existing precedent would produce several benefits and have no meaningful downside. Requiring proof of the conduct element of a violation would foster legitimate market activity by creating greater certainty for traders about the standards against which their conduct will be measured. Legal and compliance personnel and outside counsel would have objective standards to apply when providing advice about proposed transactions and trading strategies. They would no longer be forced to speculate about what a regulator, looking back through the lens of hindsight, might perceive about intent. Such subjective guesswork should not be necessary. Congress prohibited deceptive and manipulative conduct in the Anti-Manipulation Laws, whether or not through open market transactions. It may be time for the Supreme Court to clarify that its existing precedent applies equally to open market transactions.

ENDNOTES:

[1]The views expressed in this article are those of the authors alone. They do not reflect the opinions of their firm or any of its clients.

[2]Federal Power Act ("FPA") section 222, 16 U.S.C.A. § 824v; Securities and Exchange Act of 1934 ("SEA" or "Exchange Act") section 10(b), 15 U.S.C.A. § 78j(b); Energy Independence and Security Act of 2007 ("EISA") section 813, 42 U.S.C.A. § 17301; Commodity Exchange Act ("CEA") section 6(c)(1), 7 U.S.C.A. § 9(1). Collectively, we refer to these provisions as the "Anti-Manipulation Laws."

[3]18 C.F.R. § 1c.1-1c.2 (FERC Rules 1c.1 and 1c.2); 17 C.F.R. § 240.10b-5 (SEC Rule 10b-5); 17 C.F.R. § 180.1 (CFTC Rule 180.1); 16 C.F.R. § 317.3 (FTC Rule 317.3).

[4]17 C.F.R. § 180.1(a)(1).

[5]In *Santa Fe Industries v. Green*, the Supreme Court held that a "fraud" claim pursuant to SEC Rule 10b-5 (upon which FERC's rule is based) could state a claim upon which relief could be granted only if the complaint alleged deceptive or manipulative conduct *within the meaning of section 10(b) of the SEA*. 430 U.S. 462, 473-74 (1977).

[6]William Shakespeare, Hamlet act II, sc. 2.

[7]*See* George Orwell, 1984 (London: Secker and Warburg, 1949) (warning of a dystopian future state where the Thought Police (Thinkpol) were charged with rooting out thought crime).

[8]*Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 105 S. Ct. 2458, 86 L. Ed. 2d 1, Fed. Sec. L. Rep. (CCH) P 92056 (1985); *Chiarella v. U. S.*, 445 U.S. 222, 100 S. Ct. 1108, 63 L. Ed. 2d 348, Fed. Sec. L. Rep. (CCH) P 97309 (1980); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed. 2d 480, Fed. Sec. L. Rep. (CCH) P 95914 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668, Fed. Sec. L. Rep. (CCH) P 95479 (1976). *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, Fed. Sec. L. Rep. (CCH) P 91634 (3d Cir. 2001); *Gurary v. Winehouse*, 190 F.3d 37, Fed. Sec. L. Rep. (CCH) P 90,620, 45 Fed. R.

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Serv. 3d 220 (2d Cir. 1999); *Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857, Fed. Sec. L. Rep. (CCH) P 98617 (7th Cir. 1995).

[9]Mr. Millar published an article on that topic in this publication. *See* Thomas R. Millar and Sohair A. Aguirre, *The Best Defense Is a Good Offense: A Practical Framework for Analyzing and Documenting Transactions and Trading Strategies to Limit Regulatory Liability*, Futures and Derivatives Law Report Vol. 37, Iss. 4 (Apr. 2017).

[10]*PPL Electric Utilities Corp.*, 157 FERC ¶ 61,028 P 2 at n.5 (2016).

[11]CFTC Glossary: A Guide to the Language of the Futures Industry, https://www.cftc.gov/Consumer Protection/EducationCenter/CFTCGlossary/index.htm.

[12]CME Glossary, https://www.cmegroup.com/education/glossary.html.

[13]CFTC Glossary: A Guide to the Language of the Futures Industry, https://www.cftc.gov/Consumer Protection/EducationCenter/CFTCGlossary/index.htm.

[14]*Id.*

[15]CME Globex Reference Guide at 10, https://www.cmegroup.com/globex/files/GlobexRefGd.pdf.

[16]SEC Fast Answers, Limit Orders, https://www.sec.gov/fast-answers/answerslimithtm.html.

[17]CFTC Rule 180.1(b), for example, prohibits the CFTC from requiring "any person to disclose to another person nonpublic information that may be material to the market price, rate, or level of [a] commodity transaction, except as necessary to make" a statement made "in connection with the transaction not misleading in any material respect."

[18] 15 U.S.C.A. § 78j(b).

[19]The FTC's rule is based on the statutory prohibition of the "use or employ . . . [of] any manipulative or deceptive device or contrivance." 42 U.S.C.A. § 17301. However, the FTC's rule is tailored to the largely unregulated petroleum markets, which it distinguished from the highly regulated securities, natural gas and electricity markets overseen by the SEC and FERC. Those differences largely informed the FTC's decision to prohibit in its rule two categories of conduct. First, it is unlawful to "[k]nowingly engage in any act, practice, or course of business—including the making of any untrue statement of material fact—that operates or would operate as a fraud or deceit upon any person." 16 C.F.R. § 317.3(a). Second, it is unlawful to "[i]ntentionally fail to state a material fact that under the circumstances renders a statement made by such person misleading, provided that such omission distorts or is likely to distort market conditions for any such product." 16 C.F.R. § 317.3(b).

[20]17 C.F.R. § 180.1.

[21]*U.S. Commodity Futures Trading Com'n v. Parnon Energy Inc.*, 875 F. Supp. 2d 233, 249, 180 O.G.R. 169 (S.D. N.Y. 2012) (describing the elements of an attempt violation under CEA Sections 6(c) and 9(a)(2)).

[22]7 U.S.C.A. § 9(1); 16 U.S.C.A. § 824v; 15 U.S.C.A. § 78j(b); 42 U.S.C.A. § 17301.

[23]*Prohibition of Energy Market Manipulation*, Order No. 670, FERC Stats. & Regs. ¶ 31,202 at P 49, (explaining that fraud is the first element necessary to establish a violation of the Commission's Anti-Manipulation Rule), *reh'g denied*, 114 FERC ¶ 61,300 (2006) (Order No. 670).

[24]*See, e.g.*, Order No. 670, FERC Stats. & Regs. ¶ 31,202 at P 50.

[25]169 FERC ¶ 61,070 at P 59 (2019) (explaining that "[i]n light of the broad language of FPA section 222 and the Anti-Manipulation Rule, our use of the term 'well-functioning market' is not limited just to consideration of price or economically efficient outcomes in a market. Instead, we view the term to also broadly include consideration of 'such rules and regulations as the Commission may prescribe as necessary or appropriate,' which necessarily includes the rates, terms, and conditions of service in a Commission-jurisdictional market. . .").

[26]*See* Staff White Paper on Anti-Market Manipulation Enforcement Efforts Ten Years After

EPACT 2005 (Nov. 2016), https://www.ferc.gov/legal/staff-reports/2016/marketmanipulationwhitepaper.pdf (citing *Houlian Chen*, 151 FERC ¶ 61,179 at P 136 (2015) (Chen) (rejecting argument that transactions cannot be fraudulent if executed in "an open, transparent manner") and *Federal Energy Regulatory Com'n v. Barclays Bank PLC*, 105 F. Supp. 3d 1121, 1147, Comm. Fut. L. Rep. (CCH) P 33470 (E.D. Cal. 2015), as amended, (May 22, 2015) (rejecting the argument that "trades which involve willing counterparties made on the open market cannot be actionable" (citing securities law cases)).

[27]*Barclays Bank PLC*, 144 FERC ¶ 61,041 at P 59 (2013) ("Neither artificial price nor market power, however, is a necessary element required to find a violation of the FPA or the Anti-Manipulation Rule.").

[28]18 C.F.R. §§ 1c.1(a)(3), 1c.2(a)(3) (making it unlawful "[t]o engage in any act, practice, or course of business that operates or *would operate* as a fraud or deceit upon any entity" (emphasis added)); *see also Maxim Power Corp.*, 151 FERC ¶ 61,094 at n.5 (2015) (holding that "manipulation, fraud, and misrepresentations to market monitors are unacceptable in Commission-regulated markets even where such behavior is caught before it causes harm to consumers").

[29]169 FERC ¶ 61,070 at P 125.

[30]*United States Commodity Futures Trading Commission v. Wilson*, Comm. Fut. L. Rep. (CCH) P 34395, 2018 WL 6322024, at *5 (S.D. N.Y. 2018).

[31]*Id.* at *15 (emphasis added).

[32]*Id.* at *14 (emphasis added).

[33]*Id.* at *13.

[34]*U.S. Commodity Futures Trading Com'n v. Kraft Foods Group, Inc.*, 153 F. Supp. 3d 996, Comm. Fut. L. Rep. (CCH) P 33614 (N.D. Ill. 2015). The complaint does not specify what types of orders Kraft placed to acquire its large long position.

[35]*Id*. at 1014 (emphasis added).

[36]*Id*.

[37]*See Markowski v. S.E.C.*, 274 F.3d 525, 529, Fed. Sec. L. Rep. (CCH) P 91650 (D.C. Cir. 2001) (holding incorrectly that it was not unreasonable for the SEC to conclude that conduct can be manipulative "solely because of the actor's purpose").

[38]*Id.* at 527.

[39]*Id.* at 529.

[40]*Id.*

[41]*S.E.C. v. Masri*, 523 F. Supp. 2d 361, Fed. Sec. L. Rep. (CCH) P 94526 (S.D. N.Y. 2007).

[42]*Id.*

[43]*Id.*

[44]*Id.* at 372. Failing to recognize the centrality of the conduct element in both the statute and the Supreme Court's precedents, the court reasoned that "if a transaction would have been conducted for investment purposes or other economic reasons, and regardless of the manipulative purpose, then it can no longer be said that it is 'artificially' affecting the price of the security or injecting inaccurate information into the market, which is the principal concern about manipulative conduct." *Id.* at 373.

[45]430 U.S. 462, 473-74 (1977) (emphasis added).

[46]*Chiarella v. U. S.*, 445 U.S. 222, 234-35, 100 S. Ct. 1108, 63 L. Ed. 2d 348, Fed. Sec. L. Rep. (CCH) P 97309 (1980).

[47]*Santa Fe*, 430 U.S. at 476 (emphasis added).

[48]*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199, 96 S. Ct. 1375, 47 L. Ed. 2d 668, Fed. Sec. L. Rep. (CCH) P 95479 (1976) (emphasis added).

[49]*Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 7, 105 S. Ct. 2458, 86 L. Ed. 2d 1, Fed. Sec. L. Rep. (CCH) P 92056 (1985) (quoting *Hochfelder*, 425 U.S. at 199 (emphasis added by *Schrei*ber).

[50]*Id.* (citing *Santa Fe*, 430 U.S. at 476-77; *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 43, 97 S. Ct. 926, 51 L. Ed. 2d 124, Fed. Sec. L. Rep. (CCH) P 95864 (1977); *Hochfeld*er, 425 U.S. at 199).

[51]*Id.* at 7 (quoting *Hochfelder*, 425 U.S. at

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199).

[52]*Gurary v. Winehouse*, 190 F.3d 37, 45, Fed. Sec. L. Rep. (CCH) P 90,620, 45 Fed. R. Serv. 3d 220 (2d Cir. 1999) (citing *Schreiber*, 472 U.S. at 12).

[53]*Sullivan*, 47 F.3d at 862, 865 (quoting *Hochfelder*, 425 U.S. at 199) (emphasis added).

[54]*GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 204-5, Fed. Sec. L. Rep. (CCH) P 91634 (3d Cir. 2001) (explaining that violation of the anti-fraud rule in the context of an open market trade "requires . . . something beyond otherwise legal trading, [that] specifically injects false information into the market and/or creates an artificial demand for the underlying security").

[55]*See, e.g.*, *Masri*, 523 F. Supp. 2d at 367 (mischaracterizing *GFL* as requiring an unnecessary "additional" element and asserting that "Reluctant to find that legal conduct could violate securities laws based only on manipulative intent, the court additionally required 'that the alleged manipulator injected inaccurate information into the market or created a false impression of market activity.' ") (quoting *GFL*, 272 F.3d at 205).

[56]*GFL*, 272 F.3d at 205.

[57]*Santa Fe*, 430 U.S. at 473-74.

[58]*Markowski*, 274 F.3d at 529 (quoting 15 U.S.C.A. § 78i(a)(2)).

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