Finance and Accounting

Abstract

This paper focuses on the market manipulation and its impact on the future trades. A brief idea about the commodity market has been provided in the report. Based on this discussion, it has been found that in spite of the rigid regulatory framework, market manipulation has been affecting the competitive scenario of the business.

Introduction

Market manipulation is quite a controversial topic in all the commodity markets specially the futures market. The commodity futures market has been facing the market manipulation from decades. It has threatened the economy continuously and all the efforts to stop the manipulation have failed. Many have commented that redefining manipulation will be the ultimate solution for the issue. However, Jerry Markham had argued that by redefining manipulation will be ineffective for the situations and it will increase the cost. The effort will be again futile as before. He exclaimed that the Commodity Futures Trading Commission (CFTC) should be more active and empowered for adapting affirmative regulations apart from doing their predefined activities. The regulations will maintain an orderly and fair market. Thus, the CFTC will be requiring more resources than before. Markham has argued that these will reduce market manipulation and the additional cost will have limited effect on the total manipulation. The paper elaborates the effects of manipulation on commodity futures markets and also lays emphasis on its potential to cope up with the manipulation level. The paper also highlights on the trading behaviour of the major participants of the market like the customers and dealers. The elaboration of the topic is based on the futures trades that are reported to the governmental regulators by the various dealers and exchanges. The response of the prices is selective to the trading actions of the group which is selected as the market participants which are relevant at the time (Attari, Antonio and Martin, 2005).

Commodity futures market

The growth of the future market in the past thirty years has been explosive. The volume of future trading was about 3.9 million in 1960. The volume of contracts increased with the time which was due to the modifications and changes in the monetary policy. Inflation during 1960 and 1970s had also created dramatic impact on the commodity prices and thus there is huge development in the financial future contracts. The trading in the futures market has outstripped the trading in agricultural commodity future market (Pirrong, 2010).

Along with the increasing trading volume in commodity future market, many issues were raised against the trading system. The commodity futures market in United States have developed to a great extent in the past but at the end of the Civil War the contracts for the delivery of grains were switched into convertible contracts that were often used for offsetting each other. Thus, the speculators got the opportunity to undertake manipulative activities (Agarwal and Narayan, 2002). The scope for manipulation became wide spread with time and the plays of the speculators gained popularity. There were efforts in the 1880 to control these activities but all were futile due to the degree of manipulation. There were measures to prevent the cornering of the market. The CFTC were incapable of preventative the manipulative actions in the market and thus many considered to redefine manipulation so that the effects of the same will have positive impact on the trading system. However, the concept of redefining was not accepted by Jerry Markham who said that it would not increase the cost for the government and will have minute effect on the trading system. Thus, he recommended that particulars regulations should be made to control the actions.

Manipulation of commodities futures markets

History has encountered the speculators engaging in manipulative actions but corporations and individuals had also attempted to undertake manipulating actions for the securities market. These helped them to generate private returns from the exercising market power and the acquiring market. The major manipulations have occurred in the bond market as well as in the commodity futures. The manipulative actions are through grabbing the market price which was prominent in United States and United Kingdom (Collins, 2000).

The manipulative delivery has squeezed the futures market by manipulating the future long position in the bond market. The squeezed delivery attempted on making profit by providing restrictions on the supply of the cheapest deliverable issues. The actions however increased the price of original cheap delivery issue price and this forced the holders of futures contract to deliver the most highly valued issues or even they can buy the futures contract at the inflated prices. The participants of the futures market and futures exchanges are all responsible for the squeeze attempts. One such squeeze generates a period for persistent price distortion which has the ability to eat away the economic role of the futures markets. It has the strength to reduce the efficacy of the underlying futures contract after price discovery and hedging. The distortions are expected to arise before the actual delivery date of the contract. The high amount of futures trading in the market is subject to the squeezing. Larger portion of the population are aware of the adverse effect of the delivery squeezer which is relative to the cash market. The construction of the whole future market may provide a higher degree of squeeze during the phase of accumulation of the manipulative event (Massa and Zahid, 2008).

The early legislators had failed to prevent the manipulations as a result of which there was a wide need for an appropriate legislator which will abolish the manipulative actions. For determining what legislation was exactly needed for the prevention Congress had considered the obligation of limits that are given on every trade. The limits restricted the size of trades that is to be carried out by the foreigners and traders. This restriction limited the levels of manipulation that was carried out by the traders. Congress decided that the manipulation would be controlled if the transactions are recorded and those are reviewed by the governmental authority. It was thought that the legislations would help in preventing the manipulation since if a person undertakes to bear the market, the world will come to know about it and he would be the loser. Thus, they decided that secrecy would be kept in order to prevent the traders to undertake any means to manipulate the actions in the future market (Lyons, 2000). It was also decided that the future contract would be traded through the exchanges that would be responsible for preventing the manipulated activities. It was observed that if the exchange failed to do their duty, they would be losing their privilege for conducting future trading. It was reported to the Congress that the speculators who dealt with large quantities of trades were the largest players in the trade and they dominated singly by cornering markets. They controlled large blocks and had beaten the market up to down (Fabozzi, 2007).

The need for distinguishing the market manipulation from the fraud based manipulation has been understood from the historical statutory cases under respective sections and also under the standards for the artificial prices. The first enforcement action of CFTC had not occurred till 2009. Many literatures were elaborated to highlight on the manipulative markets. Goldstein and Guembel (2008 cited in Markham, 2010) had concluded that strategies for trading gives rise to misrepresentation of the equity values which creates incentives to sell and this gives opportunities for manipulations. Massa and Rehman (2008 cited Lewellen, 2006) had determined that the asset management companies had exploited secret information regarding pending loans of the bank to few large customers. These helped the traders to approach these customers to build in portfolios for themselves to earn high amounts so that they can repay the loans. It was actually trap for those customers which they did not understand at that moment and easily got manipulated. The lack of knowledge regarding the future market forced the customers to get mislead by the traders and they faced huge loses.

Conclusion

The record of manipulation from the past years in the commodity future markets had dramatically underscored the evidence that regulatory measures taken by the government had failed to work. There were huge number of speculators who were unregulated and thus there was a need for legislation which will have the ability to prevent manipulation. However, the legislation also failed to do any changes in the trading system which will benefit the investors and not the speculators. The adoption of the Commodity Exchange Act in 1936 lead to the new definition of manipulation and ways were evaluated to prevent the manipulation. However, it also failed to prohibit the manipulative practices. Later when the price of the commodities reached its peak the Congress announced CFTC grants which looked as if the market misconducts can be dealt with easily. These gave power to CFTC to charge penalty of $100,000 on the traders or speculators and take emergency actions on the misconducts.

It is believed by everybody that prosecution of manipulations are subject to the regulatory schemes. However, the courts who had been struggling with the issue of manipulation were unable to formulate the methodology that allows efficient prosecution. They were however, bogged down for the elements which have economic determinations. The determination was whether price artificiality had been achieved by the activities of trading with a particular firm. The court however, did not adopt standards that would inhibit the competition of aggressive price in the commodity futures market. Thus, the traders got the opportunity to stick to their manipulative actions.

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