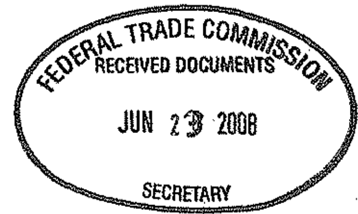

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June 23, 2008

Mr. Donald S. Clark
Secretary
Federal Trade Commission
Market Manipulation Rulemaking
Room H-135 (Annex G)
600 Pennsylvania Avenue, N.W.
Washington, DC 20580

Re: Market Manipulation Rulemaking, P082900
Prohibitions on Market Manipulation and False Information in Subtitle B of the Energy Independence and Security Act of 2007

Dear Mr. Clark:

The Committee on Futures and Derivatives Regulation (the "Committee") of the New York City Bar Association (the "Association") is pleased to provide comments on the Commission's above-referenced advance notice of proposed rulemaking concerning the manner in which the Committee should carry out its rulemaking responsibilities under Section 811 of Subtitle B of Title VIII of the Energy Independence and Security Act of 2007 ("EISA").

The Association is an organization of over 22,000 lawyers. Most of its members practice in the New York City area. However, the Association also has members in nearly every state and over 50 countries. The Committee consists of attorneys knowledgeable in the regulation of futures contracts and other derivative instruments and experienced in the representation of futures industry participants and registrants. It has a history of publishing reports analyzing regulatory issues critical to the futures industry and related activities. The Committee's interest in the proposed rulemaking arises from its potential effect on participants in cash, forward, and derivatives markets. The Committee appreciates the opportunity to comment.

The Committee commends the Commission for its detailed and thoughtful notice of proposed rulemaking ("Notice"). The Notice catalogs an extensive array of complex and consequential factual, legal and regulatory concerns at issue in establishing anti-manipulation standards for crude oil, gasoline and petroleum distillates markets. Although each of the many points raised in the Notice deserves careful investigation and analysis, the Committee's comments will focus on issues concerning legal principles of due process and fairness that will be crucial to protecting the public interest in maintaining well-functioning markets. Specifically, this comment will address:

1. The need for the Commission to adopt an anti-manipulation standard that is clear and easily understood and complied with by market participants;

2. The need to adopt a standard that advances the development of one universal definition of price manipulation for the wholesale crude oil, gasoline and petroleum distillates markets; and

3. The need for a rule that does not, either expressly or impliedly, create or alter existing obligations among market participants.

A. Summary of the Terms of a Proposed Anti-Manipulation Rule

EISA Section 811 makes it unlawful

"for any person, directly or indirectly, to use or employ, in connection with the purchase or sale of crude oil[,] gasoline or petroleum distillates at wholesale, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Federal Trade Commission may prescribe as necessary

> or appropriate in the public interest or for the protection of United States citizens."[1]

With the enactment of EISA, purchasers and sellers of wholesale crude oil, gasoline and petroleum distillates markets are now conceivably subject to the anti-manipulation prohibitions of four different statutes – Section 811 of EISA, Section 9(a)(2) of the Commodity Exchange Act ("CEA"), Section 4A of the Natural Gas Act ("NGA"), and Section 222 of the Federal Power Act ("FPA"). The Notice recognizes that the language of Section 811 is effectively identical to the anti-manipulation proscriptions found in Section 10(b) (and, we note, Section 14(e)) of the Securities Exchange Act of 1934, as amended ("Exchange Act").[2] The administration and civil enforcement of EISA, the CEA, the NGA and the FPA is reposed in three different federal agencies, namely, the Commission, the Commodity Futures Trading Commission ("CFTC") and the Federal Energy Regulatory Commission ("FERC").[3] In addition, the criminal enforcement of the CEA, NGA and FPA provisions is reposed in the Department of Justice.

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[1] The Committee believes that Section 811's reference to the commodities "at wholesale" reflects a congressional intent that the statute cover transactions in the commercial cash and forward markets for crude oil, gasoline and petroleum distillates transactions and is intended to exclude from its reach retail markets and CFTC-regulated futures markets for those products.

[2] Section 14(e) is a tender offer antifraud provision enacted in 1968 as part of the Williams Act that, as relevant here, contains the same proscriptions found in Section 10(b).

[3] Although wholesale crude oil, gasoline and petroleum distillates markets are not within the FERC's regulatory jurisdiction, FERC has interpreted its anti-manipulation enforcement powers to reach any manipulation of any market that affects pricing in the interstate natural gas and power markets that FERC regulates. Accordingly, pursuant to FERC's interpretation of its anti-manipulation authority, to the extent a manipulation of prices in wholesale crude oil, gasoline and petroleum distillates markets affects the FERC-regulated natural gas and power markets, a manipulator could be subject to FERC enforcement action.
CEA Section 2(a)(1) reposes in the CFTC exclusive jurisdiction with respect to accounts, agreements and transactions in commodity futures and options traded on CFTC-regulated exchanges. The CFTC's anti-manipulation enforcement authority has never been questioned as it applies to those accounts, agreements and transactions. The CFTC, however, also has interpreted the CEA to authorize it to bring civil enforcement actions for the violation of CEA Section 9(a)(2)'s criminal anti-manipulation prohibitions with respect to all other commodity markets as well, including cash markets,

The Notice's survey of the different legal requirements of the anti-manipulation statutes and underlying rules reflects that it is impossible to adopt a rule that is identical to the anti-manipulation standards of the other relevant statutes, but that should not be the Commission's objective in any event. Rather, the objective in advancing the public interest should be the adoption of a rule that is tailored to meet the needs of the particular wholesale crude oil, gasoline and petroleum distillates markets while being compatible with the essential anti-manipulation principles of the other relevant statutes.

The Committee believes that this objective is best met by a rule that is targeted to prohibit deceitful conduct specifically intended to subvert or disable the integrity of the market price-setting processes and mechanisms in order to cause false or fictitious non-market prices and/or transactions. The essential elements of an offense should include: (a) intentional or reckless deception of market participants, undertaken (b) with a specific intent to subvert or disable a market price-setting process or mechanism in order to cause false or fictitious non-market prices and/or transactions and (c) with the ability to cause false or fictitious non-market prices and/or transactions; and (d) the causing of false or fictitious non-market prices and/or transactions. **[c would be important to an "impossibility defense – e.g. purposely falsely reporting one small inconsequential trade that could never materially affect an index – that might be grounds for false reporting but not manipulation. d is needed to prove actual manipulation. If you prove b in virtually all circumstances you'll be able to prove a, but a is needed to prevent the rationalization that aggressive trading alone with an intent to impact price or acquiring a large forward contract position alone would be deemed conduct specifically intended to subvert market processes.]** Such a rule would be compatible with the essential objectives of the various securities and commodities law anti-manipulation standards.

B. The Anti-Manipulation Rule Must Have a Clear Legal Standard that Provides Fair Notice of the Prohibited Conduct to All Market Participants

The public interest and the protection of U.S. citizens – the primary concerns of Section 811 of EISA – are best served by the adoption of a clear legal standard for market manipulation

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forward markets, and over-the-counter financial derivatives markets. Accordingly, the CFTC would consider its anti-manipulation enforcement authority to reach to purchases and sales of crude oil, gasoline and petroleum distillates at wholesale.

that will allow market participants to conduct their business with a clear understanding of the relevant legal boundaries. As described below, the Committee believes that a comprehensive and clear rule for market manipulation is achievable. A vague legal standard not only may be unconstitutional as a matter of law but also can undermine a well-functioning market. Vague legal standards resulting in legal uncertainty and unreasonably indeterminable legal risks (1) diminish liquidity by driving producers and end-users to use non-U.S. markets instead, (2) adversely impact competition, (3) cause unnecessarily higher costs for market participants and downstream consumers as market participants adopt inefficient and uneconomical practices simply to avoid such risks, and (4) lay the groundwork for arbitrary enforcement and the undesirable unintended consequences that are sure to flow from it.

Achievement of a clear legal anti-manipulation standard requires distinguishing between a general anti-manipulation rule and its legal cousins, market management and structure rules. The two types of rules are often confused in the public discourse about commodity pricing, such as the erroneous equating of "excessive speculation" and market manipulation. The focused purpose of an anti-manipulation rule should be to prohibit conduct specifically intended to disable the market price-setting processes and mechanisms and deceive market participants in order to cause false or fictitious, non-market prices, and/or transactions. Examples of such manipulation would include corrupting prices by purposely disseminating material price information known to be false, secretly disabling the proper functioning of trading facilities, or secretly colluding with other market participants to effect wash sales or rig prices.

An objective, focused rule intended to protect the integrity of market processes is distinguishable from proactive market management and structure rules (*e.g.*, rules establishing price caps, limits on speculative positions, disclosure obligations, licensing requirements, time limits on market transactions, and financial prerequisites for market participation). Their general purpose is to manage or regulate market economics – *i.e.*, to perfect market competition, efficiency, and fair valuations and to prevent unnecessary and inefficient market constraints, congestion and turmoil. Their violation conceivably also could involve a violation of an anti-manipulation rule, but not necessarily. Adopting a broad, but vague anti-manipulation rule with the intent that it could be broad enough also to serve as an economic management tool would contravene the public interest for the reasons mentioned above.

C. <u>An Anti-Manipulation Rule Should Both be Tailored for Wholesale Crude Oil, Gasoline and Petroleum Distillates Markets and Compatible with the Anti-Manipulation Principles of the Relevant Overlapping Statutes</u>

The Committee believes the public interest requires that the Commission adopt a standard that not only is clear but also advances the development of a universal standard *for the wholesale crude oil, gasoline and petroleum distillates markets.*[4] The Committee respectfully submits that the Commission should work with the CFTC, as well as FERC, to achieve this end. To adopt a rule clearly hostile to another federal statute would contravene constitutional principles of due process. Further, for the reasons discussed above, U.S. markets and citizens would be ill-served by rules that subject market participants to inconsistent and incompatible standards.

Instances of conflicting federal statutes are relatively few. Courts typically have resolved such conflicts by divining congressional intent from the *sui generis* peculiarities of the specific statutes involved.[5] In some instances, courts have permitted inconsistent standards between redundant statutes where the statutes are enforced by the same prosecutorial body, finding that prosecutorial discretion at the time of charging can resolve any inconsistencies. In essence, discretion can remove the potential for a defendant to be subject to inconsistent laws.[6] That

[4] The Committee respectfully submits that the Commission need not in this rulemaking undertake to resolve any potential inconsistency or conflict between securities law principles and the application of CEA anti-manipulation standards *in the context of prices on CFTC-regulated commodity futures and options exchanges* because the latter is within the exclusive jurisdiction of the CFTC. In that context, the Commission should reasonably defer to the CFTC's expertise in applying anti-manipulation standards in those specialized, highly regulated exchange markets.

[5] *E.g., Credit Suisse Sec. LLC v. Billing*, 127 S. Ct. 2383 (2007) (federal antitrust statute and federal securities laws); *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979) (Employee Retirement Income Security Act and federal securities laws); *Califano v. Sanders*, 430 U.S. 99 (1977) (effect of amendment to Administrative Procedure Act); *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537 (7th Cir. 1989) (federal securities laws and CEA); and *Board of Trade of the City of Chicago v. SEC*, 677 F.2d 1137 (7th Cir. 1982) (federal securities laws and CEA).

[6] *See, e.g., U.S. v. Batchelder*, 442 U.S. 114 (1979), which resolved an inconsistency between the maximum sentences permitted by two criminal statutes that prohibited the very same conduct – felons receiving fire arms. The Court held that the two statutes were not in conflict because each statute was unambiguous on its own in its terms and the determination of which statute would be charged in any particular case was a matter

potential resolution is not possible where, as here, different agencies enforce the different overlapping statutes and each independently exercises its enforcement discretion.[7]

1. <u>Manipulation should require proof of intentionally or recklessly deceptive conduct</u>

The Supreme Court has defined the terms "manipulation" and "manipulative" in Section 10(b) of the Exchange Act and Securities and Exchange Commission ("SEC") Rule 10b-5 thereunder to denote a species of fraud involving the intentional deceit of others. In *Ernst & Ernst v. Hochfelder,*[8] the Court opined that the word "manipulative" in Section 10(b) of the Exchange Act "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." In *Santa Fe Industries, Inc. v. Green,*[9] after explaining that a plaintiff "states a cause of action under *any* part of Rule 10b-5

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properly reposed in the prosecutorial discretion of a single prosecutor. This pragmatic resolution was grounded in the fact that the same prosecutor – the United States Department of Justice – administered and prosecuted both criminal statutes.

[7] This dilemma has materialized in the CFTC's and FERC's recent inconsistent separate prosecutions against Amaranth Advisors LLC and Energy Transfer Partners LP. *Compare* Order to Show Cause and Notice of Proposed Penalties, *in re: Amaranth Advisors L.L.C., et al.*, Docket No. IN07-26-000120, FERC ¶ 61,085 (2007), *and* Order to Show Cause and Notice of Proposed Penalties, *in re: Energy Transfer Partners, L.P., et al.*, Docket No. IN06-3-000120, FERC ¶ 61,086 (2007) *with U.S. Commodity Futures Trading Commission v. Amaranth Advisors, L.L.C. et al.*, No. 1:07-cv-06682 (S.D.N.Y. filed July 25, 2007), *and U.S. Commodity Futures Trading Commission v. Energy Transfer Partners, L.P., et al.*, No. 3:07-cv-01301 (N.D. Tex. filed July 26, 2007). In each instance, the agencies are independently prosecuting the same alleged conduct under their different anti-manipulation standards. Underscoring the ambiguity and arbitrariness of the law, the different agencies have come to different conclusions as to whether a perfected manipulation occurred. The FERC has charged the respondents with causing a *perfected* manipulation. The CFTC, in contrast, has charged the same respondents with only *attempted* manipulation, which the CFTC has previously defined as overt conduct specifically intended to cause an artificial price but that fails to cause an artificial price. *E.g., In re Hohenberg Bros. Company*, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,271, p. 21,477 (CFTC 1977) ("An attempted manipulation . . . is simply a manipulation that has not succeeded – that is, the conduct engaged in has failed to create an artificial price.").

[8] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

[9] *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute,"[10] the Court opined that:

> Manipulation is virtually a term of art when used in connection with securities markets. The term refers generally to practices, *such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.* Section 10(b)'s general prohibition of practices deemed by the SEC to be manipulative – in this technical sense of artificially affecting market activity in order to mislead investors – is fully consistent with the fundamental purpose of the [Exchange] Act to substitute a philosophy of full disclosure for the philosophy of caveat emptor....[11]

Subsequently, in *Schreiber v. Burlington Northern, Inc.*,[12] the Court held that the word "manipulative" in Exchange Act Section 14(e):

> requires misrepresentations or nondisclosure. It connotes "conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199. Without misrepresentation or nondisclosure, § 14(e) has not been violated.[13]

Schreiber rejected an argument that the phrase "fraudulent, deceptive, or manipulative acts or practices" includes "acts which, although fully disclosed, 'artificially' affect the price of the takeover target stock."[14] Further, *Schreiber* specifically held that the meaning of the word "manipulative" is the same in both Exchange Act Sections 10(b) and 14(e):

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[10] *Id.* at 473-74 (emphasis added).
[11] *Id.* at 476-77 (emphasis added and internal quotations and citations omitted). "Wash sales" typically involve transactions in which traders, through secret collusion, simultaneously buy and sell the same security to each other at the same or nearly the same price – *i.e.*, "transactions involving no change in beneficial ownership." *E.g., Ernst & Ernst v. Hochfelder,* 425 U.S. at 205 n.25; *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 111 (2d Cir. 1998). "Matched orders" are similar to wash sales as orders entered for the purchase or sale of a security with the knowledge that opposite orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the purchase/sale of such security. *Ernst & Ernst v. Hochfelder*, 425 U.S. at 205 n.25. Wash sales and matched orders are condemned as creating a false picture of *bona fide* market volumes, liquidity and pricing.
[12] *Schreiber v. Burlington Northern, Inc.,* 472 U.S. 1 (1985).
[13] *Id.* at 12.
[14] *Id.* at 6.

> [Petitioner] argues . . . that the term "manipulative" takes on a meaning in § 14(e) that is different from the meaning it has in § 10(b). Petitioner claims that the use of the disjunctive "or" in § 14(e) implies that acts need not be deceptive or fraudulent to be manipulative. *But Congress used the phrase "manipulative or deceptive" in § 10(b) as well, and we have interpreted "manipulative" in that context to require misrepresentation.*[15]

The Court further expressed the concern that "[i]nviting judges to read the term 'manipulative' with their own sense of what constitutes 'unfair' or 'artificial' conduct would inject uncertainty into the tender offer process."[16]

Subsequent to *Schreiber*, the federal circuit courts of appeals generally have focused on whether the alleged manipulator engaged in misrepresentations, collusive trading or otherwise injected false supply, demand, liquidity, transactional or pricing information into the market. The United States Court of Appeals for the Third Circuit has held that actionable manipulation turns on whether the alleged manipulator "inject[ed] inaccurate information into the marketplace or creat[ed] a false impression of supply and demand for the security ... for the purpose of artificially depressing or inflating the price of the security."[17] The Second Circuit similarly has opined that market manipulation requires a showing that

> an alleged manipulator engaged in market activity *aimed at deceiving investors as to how other market participants have valued a security.* The deception arises from the fact that investors are misled to believe "that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators."[18]

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[15] *Id.* at 7-8 (emphasis added).
[16] *Id.* at 12 (emphasis added).
[17] *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 207 (3d Cir. 2007), *cert. denied*, 536 U.S. 923 (2002) ("*GFL*").
[18] *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 2007 U.S. App. LEXIS 16382, at *21 (2d Cir. 2007) (emphasis added), *quoting Guarny v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999). The legislative history of the Exchange Act also explained that: "If a person is merely trying to acquire a large block of stock for investment, or desires to dispose of a big holding, his knowledge that in doing so he will affect the market price does not make his action unlawful." H.R. Rep. No. 73-1383 (1934).

The Third Circuit in *GFL* recognized the need to "differentiate between legitimate trading activities that permissibly may influence prices, such as short sales," from the "essential element" of a claim of manipulation, which is "that inaccurate information is being injected into the marketplace."[19] In *GFL*, the plaintiff contended that the defendant manipulated stock prices by aggressive short selling with the specific purpose to depress the prices. The court rejected the claim on the basis that "short selling is a lawful investment strategy" and that

> [S]hort selling, even in large volumes, is not even of itself unlawful and therefore cannot be regarded as evidence of market manipulation. That short selling may depress share prices, which in turn may enable traders to acquire more shares for less cash (or in this case, for less debt), is not evidence of unlawful market manipulation, for they simply are natural consequences of a lawful and carefully regulated trading practice.[20]

Consistent with this, the Third Circuit in *GFL Advantage Fund, Ltd.* favorably quoted the district court that "it is unreasonable 'to infer unlawful intent from lawful activity alone.'"[21]

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[19] *GFL*, 272 F.3d at 205, *quoting In re Olympia Brewing Co. Securities Litigation*, 613 F. Supp. 1286, 1292 (N.D. Ill. 1985).
[20] *GFL*, 272 F.3d at 209. *Accord Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857, 864 (7th Cir. 1995) (concluding that Defendant's "unprecedented massive short selling" did not create "a false impression of supply and demand" because on the other side of Defendant's transactions were "real buyers, betting against [Defendant], however foolishly, that the price of [the] stock would rise"); *Olympia Brewing*, 613 F. Supp. at 1296 (stating that "short selling is simply not unlawful, even in large numbers and even if the trading does negatively affect the purchase price"). Some circuit courts have upheld SEC findings that underwriters defrauded investors by manipulating share prices in the after market of initial public offerings where they controlled the supply of shares in those nascent markets and dominated them through overly aggressive share purchases specifically for the purpose of creating and supporting unjustifiably high prices. The defendants in those cases were found to have used fraudulent devices as part of their manipulations. *E.g., Markowski v. SEC*, 274 F.3d 525 (D.C. Cir. 2001) (publishing non-bona fide quotations and violating the underwriter's restriction agreement with the NASD regarding securities inventory); *Pagel, Inc. v. SEC,* 803 F.2d 242 (8th Cir. 1986) (use of nominee accounts; distorting prices to defraud investors).
[21] *GFL,* 272 F.3d at 207, *quoting GFL Advantage Fund, Ltd. v. Colkitt*, 2000 U.S. Dist. LEXIS 21747, Memorandum and Order at 19 (M.D. Pa. July 17, 2000). Notwithstanding the foregoing authorities and the clear holding of *Schreiber*, the SEC has repeatedly found in settlement orders that "marking the close" (which has been defined as the practice of repeatedly executing the last transaction of the day in a security in order to affect the closing price) violates Section 10(b) and SEC Rule 10b-5 even if the

Including the element of deceit is consistent with securities law standards and clearly within the Commission's discretion and mission in promulgating a new rule specifically tailored for wholesale markets. Including such an element is not incompatible with the core principles of the CEA. While in CFTC's stated view, it would add an element not required by the CEA, it would not contravene its essential anti-manipulation objectives. Significantly, the application of the CEA's standards in cash markets is itself a new and evolving endeavor as the CFTC explores the regulation of new cash markets. There is no statutory definition of "manipulation" under the CEA, and for the first 81 years (from 1922 to 2003) of the CEA and its predecessor statute, The Grain Futures Act of 1922, its anti-manipulation provisions were applied exclusively in the context of pricing in the specialized, highly regulated markets of exchange-traded futures contracts.

Significantly, the most extensive judicial opinion on the application of CEA manipulation prohibitions to an alleged cash market manipulation adopted a standard that is relatively closely aligned with securities law anti-manipulation standards. In *United States v. Reliant Energy Servs.*,[22] the defendants were charged with, among other violations, manipulating the price of California electric power over several days in June 2000 by purposely withholding electric power from the California market with the specific intent to cause the market price for such power to rise. The defendants sought to dismiss the indictment based on, among other grounds, the fact

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transactions are otherwise lawful and executed without collusion. *E.g., In the Matter of Andrew S. Parlin*, Exch. Act Release No. 44679, 2001 SEC LEXIS 1622 (Aug. 10, 2001). *Parlin* involved allegations that an investment fund manager engaged in "marking the close" in order to improve closing prices on which his investment management fees would be based in order to enhance his fees. The SEC's settlement order did imply that the adviser's manipulation "operated as a fraud on them because such a trading strategy was neither disclosed to the fund investors nor authorized under its investment guidelines." *Id.* at *9-10. In addition, federal district courts have not uniformly accepted *Schreiber's* conclusion that a misrepresentation or actionable nondisclosure is required to establish a violation of Exchange Act Sections 10(b) and 14(e) and SEC Rule 10b-5 for manipulation. *E.g., SEC v. Masri*, 2007 U.S. Dist. LEXIS 86163 (S.D.N.Y. 2007) (concluding without addressing *Schreiber* that "if an investor conducts an open-market transaction with the intent of artificially affecting the price of the security, and not for any legitimate economic reason, it can constitute market manipulation").

[22] 420 F. Supp. 2d 1043 (N.D. Cal. 2006).

that the CEA's bare proscription that it is unlawful "to manipulate" was unconstitutionally vague as applied because (1) the term "manipulate" has no ordinary or plain meaning, (2) judicial explication has not remedied the term's ambiguity, and (3) the legislative history of the CEA fails to evidence a sufficient definition of the term.

The court rejected the constitutional attack as applied to the facts of that case but in doing so effectively engrafted an element of fraud or deceit onto CEA Section 9(a)(2)'s other requirements for its application in that case. The court's ruling relied on the fact that the dictionary definition of "manipulate" in 1936 contained the concept of managing or treating something "fraudulently." The court, for that and other reasons, concluded that "[t]o the extent § 9(a)(2) of the CEA makes it a crime to 'manage' the price of a commodity in interstate commerce by 'fraudulent' means, the court is less inclined to agree that the term 'manipulate' provides too vague a standard."[23] Significantly, the court found the current dictionary definitions of manipulation to be too vague to provide an "ordinary meaning" that would pass constitutional muster because they tend to define "manipulate" with terms such as "unfairly," "unscrupulously" and the like, which the court deemed to be "too subjective to afford a determinable legal standard by which criminal liability may be imposed."[24]

The court thus held that the alleged crime of manipulation would not pass constitutional muster of fair notice to the defendants as applied in that case unless manipulation also required proof of fraudulent acts by the accused. The *Reliant* court explained:

> Defendants repeatedly argue that a reasonable person would not understand that a unilateral decision to withhold one's own product from the market could be manipulation so as to affect the basic forces of supply and demand. **On this point, the court agrees with defendants and if the indictment was premised entirely on a defendant's unilateral decision to withhold its own supply, this would be a very different motion**. A seller of a commodity is acting quite rationally and legally to withhold his supply from the market if he believes that in the future the commodity will command a higher price – assuming, of course, the seller is under no duty to sell. But the government does not base the indictment solely on defendants' mere withholding of electricity."[25]

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[23] *Id.* at 1056.
[24] *Id.* at 1055.
[25] *Id.* at 1059 (emphasis added).

The court found that "most importantly" the indictment also charged defendants with the "*dissemination* of false and misleading rumors and information," and therefore concluded that, as applied in that case, a person of ordinary intelligence would understand that these defendants' specific actions in June 200 were manipulative within the meaning of the criminal manipulation provision."[26]

Similarly, a subsequent decision of another federal district court dismissed a CFTC civil enforcement action involving alleged manipulation of a feeder cattle futures contract based on lack of proof of any fraudulent acts by the defendant. The court held: "Simply stated, it is not a violation of the [anti-manipulation] statute to report feeder cattle sales to the USDA with the intention of moving the [Chicago Mercantile Exchange] index up or down – rather, to be unlawful, the reported sales must be sham or nonexistent transactions, or the reports must be knowingly false or misleading."[27] Although the CFTC continues its view that proof of deceit is not required under the CEA, it did not appeal the dismissal of its action in *Delay*.[28]

2. <u>Any adoption of recklessness as a scienter standard should adhere to settled securities law precedents that recklessness relates to the intent to deceive, not to an intent to affect market prices</u>

The common objective of both Exchange Act Section 10(b) and CEA Section 9(a)(2) is to prohibit conduct *specifically intended* to cause a price divorced from legitimate market forces and perceptions. Neither statutory scheme embraces a lesser standard than specific intent in this regard. This specific intent standard should not be confused with the application of a

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[26] *Id. at 1060.*
[27] *CFTC v. Delay*, No. 05-CV5026, 2006 U.S. Dist. LEXIS 85068, at *9-10 (D. Neb. 2006).
[28] The Committee notes that making a misrepresentation or actionable nondisclosure a necessary element of manipulation would help provide market participants with fair notice of the law's proscriptions and would diminish the potential for arbitrary *enforcement*. The traditional formulation of the elements of manipulation do not provide a meaningful, practical standard by which a trader can be reliably informed in "real time" as to when lawful aggressive bidding to obtain the best price crosses the line into seeking an unlawful "artificial" price. The history of litigated CEA manipulation cases reflects that the answer comes, if at all, only years later on the basis of economists' opinions given with the benefit of hindsight following extensive investigation, analysis, and litigation.

recklessness standard that has been permitted to establish Section 10(b)'s scienter standard of an intent to deceive, manipulate or defraud. In this connection, the judicial precedents make clear that the application of a recklessness standard for manipulation under Exchange Act Section 10(b) is concerned with whether the alleged violator was reckless with respect to whether its words or conduct would deceive, not to whether it would affect market prices.[29]

Section 10(b)'s scienter element has been defined to be "a mental state embracing an intent to deceive, manipulate, or defraud."[30] The federal courts of appeal have held that reckless conduct may satisfy that scienter element.[31] The most commonly applied definition of recklessness comes from *Sundstrand Corp. v. Sun Chemical Corp.*[32]:

> [R]eckless conduct may be defined as a highly unreasonable [act or] omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Establishing recklessness thus requires evidence from which it can be reasonably inferred that the violator acted both with (i) an "extreme departure" from standards of ordinary care *and* (ii) the danger of misleading buyers or sellers that was either known to the defendant or was so obvious that the actor must have been aware of it.[33] Courts have been rigorous in requiring

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[29] *E.g., SEC v. U.S. Environmental, Inc.*, 155 F.3d 107 (2d Cir. 1998) (broker-dealer held to be primamry violator by recklessly participating in wash sales and matched orders for stock promoter "despite the fact that someone else directed the market manipulation scheme"); *SEC v, Resch Cassin & Co., Inc.*, 362 F. Supp. 967 (S.D.N.Y. 1973) (defendant broker-dealer on notice from circumstances and market conditions that high bids were not the expression on genuine enthusiam for the stock's value but rather part of purposeful collusion to set false prices).
[30] *Ernst & Ernst v. Hochfelder*, 425 U.S. at 193 n.12.
[31] The Supreme Court has not specifically ruled on the question of whether recklessness satisfies the scienter standard.
[32] 553 F.2d 1033, 1045 (7th Cir. 1977).
[33] *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992) (*citing Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875

proof of truly extreme departures from ordinary care to support a finding of recklessness.[34] Consistent with these precedents, in the context of establishing manipulation, recklessness pertains to whether, based on a person's extreme departure from ordinary care, it can be inferred that a person was aware of the danger of misleading others. It does not relate to the violator's perception of whether conduct would have an impact on market prices.

D. <u>An Anti-Manipulation Rule Should Not Expressly or Impliedly Create New or Alter Existing Disclosure or Other Legal Obligations</u>

The Supreme Court has held that Section 10(b) and SEC Rule 10b-5 thereunder do not by themselves create new disclosure or other obligations.[35] Rather, the Supreme Court has held specifically with respect to disclosure obligations that a nondisclosure cannot be actionable

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(1977)). *Accord, e.g., R2 Investments, LDC v. Phillips*, 401 F.3d 638, 643 (5th Cir. 2005); *Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004); *Southland Sec. Corp. v. Inspire Ins. Solutions*, 365 F.3d 353, 366 (5th Cir. 2004) (*scienter* is "an essentially subjective state of mind" that "must actually exist in the individual making. . . the misrepresentation").

[34] *See, e.g., Rockies Fund v. SEC*, 428 F.3d 1088 (D.C. Cir. 2005); *Monetta Financial Servs. v. SEC*, 390 F.3d 952, 956-957 (7th Cir. 2004); *Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004); *SEC v. Steadman*, 967 F.2d 636, 642 (D.C. Cir. 1992) (declining to find *scienter* absent evidence the defendants had acted in "bad faith"); *SEC v. Morris*, 2005 WL 2000665 (S.D. Tex. 2005); *SEC v. Price Waterhouse*, 797 F. Supp. 1217 (S.D.N.Y. 1992). In one case, the SEC opined that even being "alarmingly careless" would be insufficient to establish recklessness. *In the Matter of KPMG Peat Marwick LLP*, 54 SEC 1135, 1183 (2001), *petition for review denied*, 289 F.3d 109 (D.C. Cir. 2002). An especially high standard applies to proving recklessness in an omissions case because "more than a conscious failure to disclose must be shown. Rather there must be proof that the non-disclosure was *intended to mislead*." *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11, 14 (2d Cir. 1983)(emphasis added). Courts have consistently held that it is insufficient to show that the defendant was in possession of the omitted information; rather, "it is the *danger of misleading buyers* that must be actually known or so obvious" that it reasonably can be concluded that the actor must have been aware of it. *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1260 (10th Cir. 2001) (emphasis in original) (*quoting Schlifke v. Seafirst Corp.*, 866 F.2d 935, 946 (7th Cir. 1989)).

[35] *E.g., United States v. Chiarella*, 445 U.S. 722 (1980). For example, the duty of corporate insiders to disclose all material facts before trading in their company's securities is a duty of a fiduciary at common law; it is not created by Section 10(b) or SEC Rule 10b-5. *Id.*

under SEC Rule 10b-5 in the absence of a duty at common law or an express statutory or regulatory duty to disclose all material facts.[36]

The same principles should apply to whatever anti-manipulation rule the Commission adopts here. The Commission should not promulgate a rule that purports to impose disclosure obligations on market participants where no disclosure obligations otherwise exist under current law. Indeed, a disclosure regime, which makes sense in the context of issuers who can disclose information about their business and operations, simply makes no sense, and has no historical precedent, in the commodities markets. The Commission's release proposing a specific anti-manipulation rule should make this clear. Any suggestion to the contrary that an anti-manipulation rule contemplates new disclosure obligations in the wholesale crude oil, gasoline and petroleum distillates markets would be inconsistent with Supreme Court precedent and very harmful to those markets by creating substantial legal uncertainty affecting contractual and legal obligations between counterparties.

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[36] *E.g., id.*

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[36] *E.g.*, *id.*

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