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October 27, 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, Section 811
<u>of Subtitle B of Title VIII of the Energy Independence and Security Act of 2007</u>

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 this comment on the notice of proposed rulemaking of the Federal Trade Commission ("Commission") published in the *Federal Register* on August 19, 2008 (73 *Fed. Reg.* 48317 – 48335, Aug. 19, 2008) to implement Section 811 of Subtitle B of Title VIII of the Energy Independence and Security Act of 2007 ("EISA") (hereinafter, the Commission's "Release"). The Committee also incorporates herein by reference its June 23, 2008 comment letter to the Commission's advance notice of proposed rulemaking because many of its points remain relevant to the consideration of the current Release.

The Association is an organization of over 23,000 members. 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 agrees with the Commission's Release that "EISA's plainly stated purpose" and "the core of what EISA explicitly proscribes" is "market manipulation." (73 *Fed. Reg.* at 48321 – 48322.) Developing a clear and coherent rule against market manipulation in the wholesale crude oil, gasoline and petroleum distillates markets is not an easy exercise due to the complexity of the markets themselves, the legal landscape of multiple overlapping anti-manipulation statutes and the dearth of judicial precedent explicating and adjudicating standards of culpability for manipulation in those markets and in cash commodity markets generally. The Committee commends the Commission and its staff for their commitment to promulgating a clear legal standard for market manipulation and for the diligent thinking, research and hard work amply reflected in its Release.

The Commission's Release correctly recognizes that the antecedents for Section 811 of EISA are found in Section 10(b) of the Securities Exchange Act of 1934, as amended, ("Exchange Act"). The Commission, accordingly, rightly looks to securities law precedents for guidance in shaping the legal standards and jurisprudence under EISA. The Commission's proposed rule 317.3 intentionally copies the language of Securities and Exchange Commission ("SEC") rule 10b-5 in the hopes that by "mirroring the established" SEC rule, market participants will have the benefit of the extensive body of precedent interpreting SEC Rule 10b-5 to guide their behavior, which "should reduce regulatory uncertainty and thereby assure greater compliance." (73 *Fed. Reg*. at 48322.)[1]

A. AN INTENT TO CAUSE FALSE, FICTITIOUS AND ARTIFICIAL MARKET ACTIVITY OR PRICES IS AN INTRINSIC ELEMENT OF MARKET MANIPULATION

The express terms of the Commission's proposed rule 317.3, like those of SEC rule 10b-5 for securities, establish general antifraud proscriptions that proscribe all manner of fraud in connection with the purchase or sale of wholesale crude oil, gasoline and petroleum distillates. The Committee supports the Commission's interpretation of proposed rule 317.3 that fraud and deception are an essential element of its violation, that the first element of a violation of its anti-manipulation rule is an act "that injects information that is materially false, misleading or deceptive into the marketplace" (73 *Fed. Reg.* at 48328).

The Committee respectfully submits, however, that the Commission should amplify its interpretation of the proposed rule to clarify the intent element that would apply in the instance of frauds deemed to be market manipulation. Relevant legal authorities characterize market manipulation as a species of fraud that connotes fraudulent conduct specifically intended to corrupt the integrity of market pricing processes through rigged prices or fictitious trading that deceives market participants with respect to the market prices of or market interest in a commodity. *E.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (the term manipulation "is and was virtually a term of art when used in connection with securities markets" that "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially *affecting* the price of securities"); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 494-95 (1977) (manipulation "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity"); *In re Indiana Farm Bureau Cooperative Association*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21, 796 at 28,281 – 28,282 (CFTC, 1982) (to prove the intent element of manipulation, it must be proven that the violator acted with the "specific intent" of causing an artificial price, which is a price or price trend in the market that is not reflective of supply and

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[1] The Commission's proposed rule 317.3 in that way follows the example of the Federal Energy Regulatory Commission when it adopted anti-manipulation rules for natural gas and electric power markets pursuant to the Energy Policy Act of 2005, the statutory language of which also was derived from Exchange Act Section 10(b).

demand).[2] As these authorities show, intent to cause a false, fictitious, and artificial impact on market prices or market activity is an intrinsic element of market manipulation.

A rule that does not require evidence of a specific intent to cause false, fictitious and artificial market activity or prices as an element of a violation would result in a dangerously vague rule.[3]

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[2] *Accord, e.g., Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857, 864 (7th Cir. 1995) (defendant's "unprecedented massive short selling" – which involved short selling of more shares than existed – was not actionable because market rules permitted such trades and they were not intended to create and did not create "a false impression of supply and demand" because on the other side of the defendant's transactions were "real buyers, betting against [defendant], however foolishly, that the price of [the] stock would rise"); *Trane Co. v. O'Connor Securities*, 561 F. Supp. 301, 304-305 (S.D.N.Y. 1983) (entering large orders and entering into large transactions was not manipulation where there was no intent or purpose "to create an artificial demand for Trane stock"); *SEC v. Resch-Cassin & Co.,* 362 F. Supp. 964 (S.D.N.Y. 1973) (defendant liable for market manipulation because defendant's intent to create false prices and a "false appearance of activity" was evident from its orchestration of active trading in a new issue at successively higher prices through collusion with other broker-dealers). Manipulation thus typically is focused on fraud effectuated through trading; it generally is a transactional form of fraud. One form of manipulation, however, such as the so-called "pump and dump" scheme, involves circumstances in which a investment advisers or other market participants pump up trading in the commodity or stock through, for example, false advertising, reports and rumors and then sell their positions at the resulting higher prices. *See, e.g.*, *SEC v. Park*, 99 F. Supp. 2d 889, 892 (N.D. Ill. 2000) (false recommendations to buy particular stocks); *see also*, *United States v. Reliant Energy Servs*., 420 F. Supp. 2d 1043 (C.D. Cal. 2006) (alleged manipulation by spreading false rumors about supply and demand). While those schemes do not involve corruption of market trading facilities themselves, they still represent a concerted fraudulent assault on the integrity of the market processes for a particular commodity or stock.

[3] The Committee also respectfully submits that, but for the Commission's clearly stated standard that a manipulative or deceptive act is "one that injects information that is materially false, misleading or deceptive into the marketplace" (73 *Fed. Reg.* at 48328), the Commission's suggestion that any "intentional acts that obstruct or impair wholesale petroleum markets" could constitute "fraud" is contrary to established Supreme Court precedent. As discussed in the Committee's letter dated June 23, 2008, commenting on the Commission's advance notice of proposed rulemaking (which the Committee incorporates herein by reference), fraud requires, at a minimum, a misrepresentation or actionable nondisclosure of a material fact made with scienter. *Schreiber v. Burlington Northern, Inc.,* 472 U.S. 1, 6-8 and 12 (1985); *United States v. Chiarella*, 445 U.S. 722

The following is a simple, but by no means exclusive, example of why the element of intent to cause false, fictitious and artificial market activity or pricing is necessary to distinguish legitimate trading from that involving manipulation of markets. Commodity trading ultimately is a competition among market participants for favorable prices. As in all commodities trading, participants develop strategies to profit from the perceived future valuation of a commodity for the benefit of their commercial business or proprietary trading positions. To develop successful strategies will require talent in commodity valuation, astute assessment of market sentiment and behavior, and the savvy and skillful execution of trades.

The ability to execute on each of those elements can turn on the quality of a participant's market information. Consequently, an intensely active market for information is part and parcel of commodity market trading. An important aspect of that information can come from speaking with other participants to try to discern their intentions and astutely evaluating whatever information can be gleaned about the completed trades of other market participants. Market participants thus often guard information about their positions, intentions, vulnerabilities, weaknesses and strengths closely because the discovery of it by the rest of the market can allow others to take actions that quickly exploit the trader's weakness, destroy its strength, or otherwise change the market fundamentals that had supported the previously well-founded and prescient market analysis.

The legitimate need to guard proprietary information from discovery affects trade execution strategies because the manner of execution can in fact signal the market as to a participant's intentions thereby compromising its ability to capitalize on its acumen. This is particularly true in cash, forward and over-the-counter markets because in those markets, unlike futures markets where trading is done anonymously by virtue of the exchange trading facility,

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(1980); *Santa Fe Indus., Inc. v. Green*, 430 U.S. at 473-74; and *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199. The Commission's citation to *Dennis v. United States*, 384 U.S. 855, 861 (1966), as support for its "obstruction" and "impairment" theory is misplaced. That case had nothing to do with securities law or manipulation of markets, and the legal premise for which it is cited is not in keeping with *United States v. Chiarella*, 445 U.S. 722. Further, the Committee is concerned that terms like "obstruction" or "impairment" have no legal definition and would not satisfy constitutional due process standards of notice of what conduct is prohibited because clearly lawful conduct could fall within the vague and subjective concepts of "obstruction" and "impairment."

the identities of the transacting parties will be made known to each other either when seeking a trade or when the trade is executed. Further, it is a fact of cash, forward and over-the-counter commodity markets that information about a participant's transactions can spread rapidly throughout the market through telephone calls, instant messages and emails among traders.

Consequently, a common and sometimes essential part of a market participant's trade execution objectives and tactics will be to camouflage its intentions and net positions from discovery through execution strategies that, for example, involve both buying and selling the same commodity on the same day even if, for example, the objective is to accumulate a net position either long or short. For example, if a participant is bullish and wants to accumulate a large long position, it still might execute a number of sale transactions – even large ones – along the way in hopes that such a "misdirection" trade will make it less likely that the rest of the market will detect its trading view and intentions. Moreover, in such execution strategies it is not impossible that the participant will trade in and out of positions at the same price and perhaps even the same amount, which might be akin to a prohibited wash trade, *except for the lack of an illicit intent* and collusion that traditionally have distinguished wash trades from legitimate offsetting trades at the same price and quantity. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. at 205, n.25.

A Commission anti-manipulation rule that does not require intent to cause false, fictitious and artificial market activity or pricing as an essential element of a violation could expose participants to the threat of arbitrary and unfair enforcement. In the example above one might argue that the participant's misdirection trades at one level were designed to bluff the market because they were entered into to camouflage its overall trading objective. Among the reasons they are legitimate trades is that they were executed within the regular market processes, at arm's length, with actual exposure to market risk, and *without any intent to create false market activity or a rigged price.*

One of the elements of manipulation that the Commodity Futures Trading Commission ("CFTC") has applied in its administrative decisions for violation of Section 9(a)(2) of the Commodity Exchange Act ("CEA") is a specific intent to cause an artificial price, which the CFTC has defined as a price that is not reflective of the legitimate forces of supply and demand. *E.g., In re Cox*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786 (CFTC, 1987).

That standard has developed and been applied within the specialized markets of regulated exchange-traded commodity futures contracts, where price artificiality typically concerns the narrow question of the rationality of the differential between a futures price and the cash price at a particular futures contract delivery point. The CFTC has indicated it would apply the same standard to any cash market transactions within its jurisdiction, although its meaning, how it is to be applied, and the contours of its application in cash markets are not clear and remain open questions. Nonetheless, the Commission's recognition of an element of specific intent to cause false, fictitious, artificial market activity or pricing would substantially help to harmonize the legal standards between the Commission's rule and the CFTC's interpretation of the CEA. Such a result would likely promote fairness and reduce regulatory and legal uncertainty over the standards that govern participants in regulated futures markets.

B. THERE CAN BE FACTUAL CIRCUMSTANCES FOR WHICH THE EXISTENCE OR ABSENCE OF A MATERIAL MARKET PRICE IMPACT FROM TRADING ACTIVITY CAN BE AN ESSENTIAL ELEMENT IN DETERMINING WHETHER CONDUCT IS IN FACT A MANIPULATION

The Committee believes that the effect of allegedly manipulative conduct on market prices can in some circumstances be relevant to the determination of a violation. Factual circumstances could arise where the absence of any material effect -- or any effect -- on market prices could be probative on a host of issues, including, among others, the presence or absence of an illicit intent or deception in fact. Such an issue could arise, for example, where the legal and factual issues concern the contemporaneous separate and independent acts of multiple participants or competing bidders. The presence or absence of an effect on market price from any one of the alleged violators' conduct could be probative as to the proper characterization of an entity's or person's intent or whether other market participants were in fact deceived by the alleged misconduct. The Committee also recognizes that, in some factual circumstances, proof of a material effect on market prices might not be an essential element of a prima facie case or adjudicated finding of manipulation. But that potential does not warrant categorically dismissing the importance of price effects for all cases. The relevance and importance of a material effect on market prices to a prima facie case or adjudication should be determined on a case-by-case basis.

In addition, the Committee notes that the jurisprudence on market price manipulation requires that to prove a price manipulation there must be substantial proof, at a minimum, of a material price effect causing market prices not to be reflective of the actual legitimate forces of supply and demand.[4] Such forces include, among other things, deliverable supplies and demand arising from the commercial or retail needs for use of the physical commodity and the contractual or economic needs of market participants to close out open market positions due to rising or falling market prices or, with respect to naked short sellers, their failure responsibly and timely to obtain supplies in order to honor their open contractual delivery commitments.

C. THE COMMISSION SHOULD REFRAIN FROM ASSERTING JURISDICTION OVER CFTC-REGULATED COMMODITY FUTURES TRANSACTIONS AND PRICES

From the inception of the federal regulation of commodity futures transactions in 1921 to the present, Congress has treated regulated futures as a specialized market that requires specialized regulation. Congress reinforced that policy in 1974 by amending the CEA to repose exclusive jurisdiction in one federal regulator – the CFTC – for that specialized market. The CEA confers robust regulatory, market surveillance, and enforcement powers on the CFTC with respect to transactions in commodity futures, and the CFTC aggressively exercises those powers. Accordingly, the public's interest in fair and honest dealing on futures markets is fully protected by the CEA's statutory scheme and the CFTC's authority.

For these reasons, the Committee respectfully submits that the Commission should refrain from asserting enforcement authority over futures trading. The Committee recognizes that the plain terms of EISA read in a vacuum are amenable to an interpretation that manipulation of CFTC-regulated commodity futures prices would be within EISA's reach if they caused prices for wholesale transactions of crude oil, gasoline, and petroleum distillates to be manipulated. EISA, however, does not exist in a vacuum; absent clear statutory direction to the contrary, it is not reasonable to conclude that Congress intended to impliedly repeal the statutory grant of exclusive jurisdiction to the CFTC with respect to regulated futures transactions. Nothing in EISA or its legislative history provides sufficient direction that Congress

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[4] *See, e.g., In re Cox*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786 (CFTC, 1987).

intended that EISA repeal the CFTC's exclusive jurisdiction with respect to regulated futures transactions.[5]

The Committee further notes that regulated commodity futures markets, which are derivatives markets, are distinguishable from wholesale markets, which are cash markets. It would seem illogical to apply a rule under EISA that is specifically intended to govern activities in the distinct circumstances of cash markets to a specialized derivatives market that is not within EISA's scope and is separately regulated by the CFTC under its own unique and extensive set of rules and standards. The regulatory and legal uncertainty that could arise from the application of competing and potentially incongruous standards to the same marketplace could be deleterious to the functioning of futures markets and the benefits they can provide the American economy and, accordingly, would not be in the public's interest.

The Committee appreciates the opportunity to provide these comments.

Very truly yours,

Michael S. Sackheim
Chair
Committee on Futures and Derivatives Regulation

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[5] The Committee supports and encourages the Commission to follow the analysis and conclusions regarding the CFTC's exclusive jurisdiction set forth in the joint comment letter dated October 7, 2008 of the Futures Industry Association, CME Group, Inc., Managed Funds Association, National Futures Association, and the Intercontinental Exchange, Inc.

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¶This member of the Committee did not participate in this comment letter.