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NFA
NATIONAL FUTURES ASSOCIATION

October 17, 2008

VIA ELECTRONIC MAIL:
https://secure.commentworks.com/ftc-marketmanipulationNPRM/

Attention: Donald S. Clark, Secretary
Federal Trade Commission
Office of the Secretary
Room H-135 (Annex G)
600 Pennsylvania Avenue, NW
Washington, DC 20580

Re: Market Manipulation Rulemaking, PO82900

Dear Mr. Clark:

In 2007, Congress passed Section 811 of the Energy Independence and Security Act ("EISA") which authorized the Federal Trade Commission ("Commission") to issue regulations making it unlawful to use or employ any manipulative device or contrivance when buying or selling at wholesale crude oil, gasoline or petroleum distillates. On May 7, 2008, the Commission issued an Advanced Notice of Proposed Rulemaking on whether to exercise that Section 811 authority and, if so, what the regulations should provide. 73 Fed. Reg. 25614. In response, the Commission received 155 public comments. Following its review of those comments, the Commission decided to propose Part 317 of its rules to create a new prohibition for wholesale purchase and sale transactions in crude oil, gasoline and petroleum distillates. 73

Fed. Reg. 48317. Proposed Rule 317.3 would generally mirror the securities law prohibitions found in Rule 10b-5 of the Securities and Exchange Commission ("SEC"). The Commission has requested public comment on its proposal.

The undersigned Futures Industry Association, CME Group, Inc.,[1] Managed Funds Association, Intercontinental Exchange, Inc.,[2] and National Futures Association[3] ("Group") submit these comments on the Commission's proposal. The Futures Group requests that the Commission:

1) Reverse its decision to override the Commodity Exchange Act's ("CEA") grant of "exclusive jurisdiction" to the Commodity Futures Trading Commission ("CFTC") over all futures and options trading, including energy futures and options, (7 U.S.C. § 2(a)(1)(A)) and adopt an appropriate safe harbor exemption from the prohibitions in the Commission's proposed Rule 317.3 as described in our comment letter of June 23, 2008 (Section I);

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1 CME Group now owns and operates four different U.S. futures exchanges: Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), New York Mercantile Exchange Inc. ("NYMEX") and Commodity Exchange, Inc. ("COMEX"). CME Group, the Futures Industry Association and the Managed Funds Association were described in our comment letter of June 23, 2008.

2 Intercontinental Exchange, Inc. owns three futures exchanges: ICE Futures U.S. (formerly the New York Board of Trade), ICE Futures Europe, and ICE Futures Canada (formerly the Winnipeg Commodity Exchange). ICE also operates an over the counter energy trading platform, which is an exempt commercial market, as defined by the Commodity Exchange Act.

3 National Futures Association ("NFA") is a registered futures association under Section 17 of the CEA and a limited-purpose national securities association under Section 15A(k) of the Securities Exchange Act of 1934. As the industry-wide self-regulatory organization for the U.S. futures industry, NFA is first and foremost a regulatory body devoted to customer protection. NFA regulates the activities of over 3,700 Member firms that include futures commission merchants, introducing brokers, commodity pool operators and commodity trading advisors. NFA also regulates the activities of approximately 55,000 registered account executives who work for those Members.

2) Explicitly restrict the scope of proposed Rule 317.3 to make it inapplicable to ethanol as well as sugar, corn and other commodities, which may be used in the process of making ethanol, that are the subject of futures and options trading (Section II); and

3) Impose specific intent and price effects requirements as elements of an offense under the final version of proposed Rule 317.3 in order to avoid having its provisions contradict and conflict with CEA legal requirements unless the Commission adopts our suggestions in Sections I and II.

I. The Commission's Final Rule Must Comport with the CEA's Exclusive Jurisdiction Provision.

In our June comment letter, the Futures Group described in detail the statutory text, history, and public policy principles that support the CEA's grant of exclusive jurisdiction to the CFTC. *See* Futures Group Letter of June 23, 2008. As we demonstrated, Congress designed the CFTC's exclusive jurisdiction to make absolutely certain that the provisions of the CEA, as well as the CFTC's regulations issued pursuant to that statute, would be the sole legal standards applicable to futures trading. As the Commission itself acknowledged in 2000, Congress provided the CFTC with exclusive jurisdiction "to create uniform rules for the operation of the futures market." FTC Denial of Petition to Quash Civil Investigative Demands-File No. 9923259 at 5 (Feb. 25, 2000). The Commission's proposed Rule 317.3 would upset that uniformity.

The reasons for the preclusive grant of CFTC exclusive jurisdiction are well documented. In 1974, when the CFTC was created, Congress feared conflicting or duplicative regulation would be applied to futures trading activities by other federal agencies or state regulatory bodies, a legal and compliance burden Congress believed would impair the operations of U.S. futures markets. Congress enacted CFTC exclusive jurisdiction to avoid the conflicts and inefficiencies that plagued securities regulation and has amended the CEA many times over the years, and amended it again as recently as a few months ago, to ensure that the CFTC would be the sole regulator of the futures markets and related markets.[4]

As we also discussed in our June letter, every court to address the merits of this issue has found the CFTC's exclusive jurisdiction supersedes other agencies' efforts to regulate futures trading and the market operations that comprise the futures industry. We cited two major decisions by the U.S. Court of Appeals for the Seventh Circuit which the Commission thus far has ignored in this rulemaking. *Board of Trade of City of Chicago v. SEC*, 677 F.2d 1137 (7th Cir. 1982) and *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537 (7th Cir. 1989). In one of those decisions, the Seventh Circuit dealt with the interplay of the first two sentences in 7 U.S.C. § 2(a)(1)(A) and established that the first sentence grants the CFTC exclusive regulatory jurisdiction over commodity futures and options, while the second sentence recognizes that other agencies may have jurisdiction "except as hereinabove provided," that is, except for those activities covered by -- "the [CFTC] exclusive jurisdiction clause." *Board of Trade of City of Chicago v. SEC*, 677 F.2d 1137, 1145 (7th Cir. 1982).[5]

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4 As described in our June 23 letter, in the 2008 Farm Bill, Congress created a new type of statutory classification, called a "significant price discovery contract," that is analogous to a futures contract and made sure that CFTC regulation of the trading of such contracts would be subject to exclusive CFTC jurisdiction. Pub. L. No. 110-246, 122 Stat. 1651, 2201 (June 18, 2008). We have attached a full and up-to-date version of the CEA's exclusive jurisdiction provision to this letter.

5 Apparently relying on the second sentence in 7 U.S.C. § 2(a)(1)(A), and disregarding Seventh Circuit precedent that is directly to the contrary, the Commission claims "CFTC exclusive jurisdiction is not intended to remove jurisdiction conferred to other agencies under other laws." 73 Fed. Reg. at 48324, n.90. The Commission cites three cases in support of this position. The first, *FTC v. Roberts*, 276 F.3d 583 (D.C. Cir. 2001), actually supports CFTC exclusive jurisdiction over futures price manipulation. In *Roberts* the DC Circuit rejected a challenge to a Commission investigatory subpoena, holding that a marketer of educational courses in futures trading had not made a "compelling enough" argument that those sales activities were covered by CFTC exclusive jurisdiction over "transactions involving" futures contracts "to overcome this court's long-standing chariness about entertaining challenges to administrative subpoenas." 276 F.3d at 592. The Court contrasted activities that would be subject to CFTC exclusive jurisdiction, for example, "actions closely linked to the

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Despite this legal authority and unbroken chain of precedent, the Commission concluded that "CFTC authority over manipulation relating to commodities futures markets is not exclusive and, moreover, is separate from CFTC's exclusive authority under CEA Section 2(a)(1)(A)." 73 Fed. Reg. at 48324. Respectfully, the Commission misreads the CEA. The Commission's conclusion depends on the assumption that Congress limited the CFTC's exclusive jurisdiction to the futures contract instruments themselves, but not the activity involved in trading those contracts, including attempted or actual price manipulation. That view is precluded by the CEA. Congress stated the purpose of the CEA as follows: "it is further the purpose of the [CEA] ... to deter and prevent price manipulation." 7 U.S.C. § 5(b). To that end, the CEA's comprehensive regulatory protections and prohibitions apply to everyone who trades futures contracts and the various professionals and markets through which futures are traded. Granting the CFTC

(Footnote Continued)

actual trading of commodities," with marketing instructional videos that might or might not result in actual futures trading. The *Roberts* courts read the CFTC's exclusive jurisdiction to apply to "business deals that involve the buying and selling of futures," a conclusion the court found "comports with Congress' goals of conferring on the CFTC sole regulatory authority over futures contract markets...." 276 F. 3d at 590. Most tellingly, the court analyzed carefully the meaning of the first sentence in 7 U.S.C. § 2(a)(1)(A) granting exclusive CFTC jurisdiction and did not rely on the second sentence in that provision, the so-called agency savings clause, because the Commission and other agencies "retain their jurisdiction" only for those matters "beyond" what Congress covered in the first sentence, the actual trading of futures. 276 F.3d at 591. Futures manipulation involves the actual trading of futures and therefore *Roberts* undermines the Commission's position in footnote 90.

The Commission also relies upon and misconstrues two district court decisions; neither concerned futures transactions or other matters within CFTC exclusive jurisdiction. In *SEC vs. Hopper,* 2006 WL 778640 (S.D. Tex. March 24, 2006) the SEC alleged that the defendants issued false corporate disclosures of their companies' trading activities relating to sham non-futures energy transactions. The court rejected an attempt by the defendants to raise a CFTC exclusive jurisdiction defense because neither the corporate disclosures nor the non-futures transactions were covered by CFTC exclusive jurisdiction. *US vs. Reliant Energy Services, Inc.*, 420 F. Supp.2d 1043 (N.D. Cal. 2006) did not even mention the CFTC's "exclusive jurisdiction" over futures. Instead, it merely held that criminal prosecutions for non-futures commodity price manipulation may be brought under the CEA without disturbing the "exclusive regulatory authority" of the Federal Energy Regulatory Commission.

exclusive jurisdiction over instruments, but not trading, would defeat the very congressional purpose that the Commission itself identified in 2000. See *infra* at 3.

Moreover, the statutory terms that Congress enacted do not limit the CFTC's exclusive jurisdiction to just the futures contract instruments themselves. Congress expressly and broadly intended that CFTC exclusive jurisdiction would apply "with respect to accounts, agreements ... and transactions involving" futures and options contracts "traded or executed" on a regulated market. 7 U.S.C. § 2(a)(1)(A). By focusing on the forms and means for trading (accounts, agreements and transactions), as well as the actual trading of futures contracts, Congress made clear that, without limitation, the CFTC's exclusive jurisdiction covered those whose futures trading practices might constitute price manipulation.[6]

The Commission's failure to apply the CEA's exclusive jurisdiction provision as written is surprising because only six years ago the Commission endorsed a different and more accurate view in its Supreme Court brief filed in the *Roberts* case. There, the Commission unambiguously stated: "7 U.S.C. § 2(a)(1)(A) gives the CFTC exclusive jurisdiction over the regulation of commodities and commodities trading markets." Brief For Respondent-FTC, *Ken Roberts Co. v. FTC*, No. 01-1772, 537 U.S. 820 (cert denied), 2002 WL 32135703 at * 5 (August 2, 2002). Citing the *Roberts* decision itself, the Commission explained that "the CEA

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6 Congress enacted the CEA's exclusive jurisdiction provision in 1974 as part of the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389. One additional provision of the 1974 Act, Section 412, confirms our reading of the exclusive jurisdiction provision. In Section 412, Congress made clear that if other agencies, other than the new CFTC of course, had started proceedings under other laws against futures traders or brokers before the 1974 amendments took effect, those proceedings "shall not be abated by reason of any provision of this Act." 88 Stat. 1414. This provision was needed, in the words of the Tenth Circuit to avoid the creation of a "no man's land," where pre-1974 misconduct, like fraud or manipulation, which post-1974 fell within the CFTC's exclusive jurisdiction, could not be reached by other regulatory bodies. See *SEC v. American Commodity Exchange, Inc.*, 546 F.2d 1361, 1367-69 (10th Cir. 1976). If Congress had not intended CFTC exclusive jurisdiction to include fraudulent or manipulative misconduct with respect to futures trading, Section 412 would not have been necessary.

contemplates 'a regime in which other agencies may share power with the CFTC over activities that **lie outside** the scope of 7 U.S.C. § 2(a)(1)(A), but within other jurisdictional authority of the CFTC.'" *Id.* Emphasis added.

Futures price manipulation prevention and prosecution do not "lie outside" the CEA's exclusive jurisdiction provision; price manipulation prevention and prosecution lie at the heart of the CEA and the CFTC's regulatory mission. See 7 U.S.C. § 5(b). Under the Commission's view, however, the CFTC's exclusive jurisdiction would shrink to nothing because each substantive regulatory provision of the CEA "is separate from" the CEA's exclusive jurisdiction clause, including all the statute's price manipulation prohibitions. Each of the substantive regulatory provisions and enforcement prohibitions in the CEA -- from registration, position reporting, recordkeeping, and speculative limits to anti-fraud and anti-manipulation prohibitions -- are contained in provisions "separate from" the CEA's exclusive jurisdiction. As a result, the Commission's new reading would empower the SEC to regulate futures on securities and securities indexes; the Treasury Department to regulate futures on exempt securities and foreign currency; the Energy Department, Federal Energy Regulatory Commission ("FERC") as well as the Commission to regulate energy futures trading; the Environmental Protection Agency to regulate emissions credit futures trading; and the Agriculture Department to regulate agricultural futures trading. This is exactly the result -- balkanized, duplicative and conflicting regulation -- that Congress designed the CEA's broadly-stated exclusive jurisdiction provision to avoid.[7]

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7 See *e.g.* S. Rep. No. 95-850 at 23 (1978). ("The vesting of jurisdiction to regulate commodity futures trading in more than one agency would only lead to costly duplication and possible conflict of regulation or over-regulation.") The feared costs of multiple agency jurisdiction over futures markets are not merely hypothetical. As described in our June 23, 2008 letter at 14, FERC has asserted jurisdiction over pure futures market trading activities in the Amaranth case, based on FERC's restrictive and incorrect view of CFTC exclusive jurisdiction. In one instance, FERC's asserted authority caused NYMEX to lose significant market liquidity in its natural gas
(Footnote Continued...)

Congress did not intend the CFTC's exclusive jurisdiction provision to be a nullity. No rules of statutory construction would favor disregarding the plain meaning of a statute's text in order to adopt a tortured interpretation that makes the statute meaningless. *See Williamson v. United States,* 512 U.S. 594 (1994) (Noting the "general presumption that Congress does not enact statutes that have almost no effect.") and *Trichilo v. Sec'y of Health & Human Servs.*, 823 F.2d 702, 706 (2d Cir.1987) ("[W]e will not interpret a statute so that some of its terms are rendered a nullity"). No court has ever read the CFTC's exclusive jurisdiction provision to be a nullity. Neither has any agency, including the Commission, ever read the provision in that manner. The Commission should reconsider and remedy its recent misreading of the CEA's exclusive jurisdiction provision. The appropriate remedy is the addition of a safe harbor to the Commission's final Rule which recognizes the exclusive jurisdiction of the CFTC as understood and articulated by the Commission in its *Roberts* brief,[8] an interpretation shared by the Futures Group.

(Footnote Continued)

futures contract on the last day of trading in an expiring contract month, including in particular during the final 30-minute closing range that is used for purposes of establishing the final settlement price for that contract month. This is significant because this final settlement price is used as a price benchmark. See Futures & Derivatives Law Report, Brian Regan and De'ana Dow, "Cases Studies: Recent Legislative and Regulatory Developments in Response to Changes in Natural Gas Markets, 13, 22-23 (July/August 2008) (FERC insisted on NYMEX regulatory changes resulting in 40% loss of market volume in last day of trading). (The article is attached.)

8 The Commission advised the Court that CFTC exclusive jurisdiction was properly recognized in a string of cases concerning "regulation of the actual sale of options or futures contracts." *See* Roberts Cert Brief *10 (citing) *Chicago Mercantile Exch. v. SEC,* 883 F.2d 537 (7th Cir. 1989), cert. denied, 496 U.S. 936 (1990) (trading of futures contracts); *Board of Trade v. SEC,* 677 F.2d 1137 (7th Cir.), vacated as moot, 459 U.S. 1026 (1982) (trading in options on mortgage-backed certificates); *SEC v. American Commodity Exch., Inc.*, 546 F.2d 1361 (10th Cir. 1976) (regulation of fictitious commodity options enterprise); *International Trading, Ltd. v. Bell,* 556 S.W.2d 420 (Ark. 1977), cert. denied, 436 U.S. 956 (1978) (deceptive sale of commodity options contracts); *Clayton Brokerage Co. v. Mouer,* 531 S.W.2d 805 (Tex. 1975) (sale of commodity options contracts); *Minnesota v. Coin Wholesalers, Inc.*, 250 N.W.2d 583 (Minn. 1976) (sale of silver coins on margin).

As described in our June 23 letter, a safe harbor from the final Commission rule is most appropriate where the alleged misconduct -- whether actual or attempted price manipulation, fraud or false reporting -- occurs solely with respect to futures trading activities which we have shown is subject to the CEA's exclusive jurisdiction provision, as in the *Amaranth* case. The CFTC's exclusive jurisdiction must be recognized even where futures prices that have been the subject of an alleged manipulation were disseminated to and relied upon by others in physical wholesale markets. Otherwise the statutory text and congressional purpose of the CEA's exclusive jurisdiction would have little meaning because futures prices are routinely disseminated to and relied upon by businesses and non-futures market participants world-wide, as Congress well understands. 7 U.S.C. § 5(a). Different considerations, however, may apply when the alleged misconduct occurs in both the futures market and the physical wholesale market. In that circumstance, where the result of the alleged misconduct is a futures price manipulation, including an artificial futures price, we still believe the CFTC's exclusive jurisdiction should control. But we understand, and recommend, that the Commission and the CFTC may develop and implement guidelines to coordinate their enforcement activities where the misconduct did not involve only futures trading activities.

In many instances when two agencies have overlapping jurisdiction, it is appropriate, as the Commission insists (73 Fed. Reg. at 48324-25), for both agencies to share jurisdiction and to work cooperatively to achieve the public interest. That is why our June 23, 2008, letter called for the Commission and the CFTC to coordinate enforcement in non-futures areas outside the CEA's exclusive jurisdiction. But congressional grants of exclusive jurisdiction, by their express terms, and by their infrequency, are the exceptions to this general rule and embody special congressional purposes that all agencies must respect. Congress could have created the CFTC in

1974 and given it merely "jurisdiction" as opposed to "exclusive jurisdiction." Congress chose the latter. The Commission must follow the words in the CEA as Congress wrote them, affording the word "exclusive" the full measure of statutory authority that the common and ordinary understanding of the term conveys. *Asgrow Seed Co. v. Winterboer,* 513 U.S. 179, 187 (1995) ("When terms used in a statute are undefined, we give them their ordinary meaning.").

The safe harbor we have recommended to the Commission is compelled by the language and purposes of the grant of exclusive jurisdiction in the CEA. The Commission should adopt that safe harbor in its final rules.

II. The Commission Should Clarify Its Definition of Gasoline.

The Commission described its definition of "gasoline," in proposed Rule 317.2(b) to include "ethanol." According to the Commission, "manipulative or deceptive conduct involving non-petroleum based commodities that directly or indirectly affect the price of gasoline (e.g., ethanol) ... may be the subject of Commission enforcement under the proposed Rule." 73 Fed. Reg. at 48325. Section 811 of EISA, however, does not mention or authorize the application of the Commission's prohibition to "non-petroleum based commodities." Nevertheless, the Commission contends "manipulation of ethanol may be covered under the proposed Rule where changes in ethanol or other commodity prices directly or indirectly affect wholesale gasoline prices." 73 Fed. Reg. at 48325.

Section 811 does not authorize the Commission to prohibit any misconduct that directly or indirectly affects wholesale gasoline prices. Section 811 merely allows the Commission to prohibit, the "direct or indirect" use or employment of a manipulative device or contrivance in connection with a wholesale gasoline sale or purchase; that is, someone either directly uses a manipulative device or works in concert with someone else who uses the manipulative device and thereby "indirectly" uses the device. The phrase "directly or indirectly" modifies "use or employ" in Section 811, nothing more or less. In fact, Section 811 does not refer at all to "price" and surely does not expressly prohibit conduct "indirectly affecting wholesale gasoline prices."

The Commission is correct that Section 811 appears to have been modeled after Section 10(b) of the Securities Exchange Act. Not even the SEC has ever attempted to stretch the reach of Section 10(b) to cover misconduct in a commodity futures market that might affect the price of a security. For example, the SEC has never claimed that a silver price manipulation in the futures market has indirectly affected the price of a mining company's stock and therefore was actionable under SEC Rule 10b-5. Nor has the SEC ever contended that a price manipulation of silver futures constituted a manipulative device in a mining company's stock, a price manipulation of copper futures constituted a manipulative device in an electronics company's stock or a price manipulation in crude oil or natural gas futures constituted a manipulative device in an energy company's stock.

The SEC has never asserted these claims because it knows Section 10(b) does not allow it (and the CEA's exclusive jurisdiction provision would bar it, in any event). The Commission should similarly interpret Section 811 not to cover activities in collateral markets that might be shown to have a price effect on wholesale gasoline purchases or sales.

The Commission's use of "ethanol" as an example of a non-petroleum based commodity illustrates well the legal and practical reasons that should compel the Commission to reconsider its position. Ethanol, an alternative fuel that is an additive in certain gasoline blends, is subject to futures trading and therefore is a statutory "commodity" under the CEA. 7 U.S.C. § 1a (4). Ethanol futures trading is subject to the CFTC's exclusive jurisdiction and should not be subject to proposed Rule 317.3. Moreover, ethanol can be produced from a variety of agricultural feedstocks, some of which also are the subject of futures trading. The most common type of ethanol in the United States is produced from corn, a commodity that is the subject of futures trading on CBOT. In other parts of the world, ethanol is produced from sugar, a commodity that is the subject of futures trading on NYMEX and ICE Futures U.S. In addition, there is active research being conducted to derive ethanol from a wide variety of other agricultural sources.[9]

Under the Commission's proposed definition of "gasoline," futures and options trading in corn and sugar, and perhaps even other agricultural commodities, could become subject to the Commission's regulatory jurisdiction. Nothing in EISA suggests that Congress intended to grant the FTC authority over price manipulation in ethanol or agricultural commodities. Agricultural commodities are the historical core of the CEA and CFTC regulation. Futures trading in ethanol and related agricultural commodities squarely falls within the CFTC's exclusive regulatory jurisdiction. 7 U.S.C. § 2(a)(1)(A). For these reasons, the Futures Group requests that the Commission delete its reference to "ethanol" as a subset of "gasoline" within the ambit of the proposed Rule 317.3 and clarify that conduct that merely indirectly affects gasoline prices is outside the scope of proposed Rule 317.3.

III. The Commission's Proposed Rule Contradicts the CEA in Material Respects.

The Commission emphasized that its proposed rule "is not intended to impose contradictory requirements on regulated entities in the futures markets or otherwise." 73 Fed. Reg. at 48325. The Futures Group understands that the Commission does not intend to impose

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9 See http://www.ers.usda.gov/AmberWaves/April06/Features/Ethanol.htm The Commission's expansive view of gasoline to include other commodities that may effect indirectly gasoline prices could also cause interest rate or foreign currency futures trading activities to become subject to the Commission's enforcement powers under proposed Rule 317.3 if the Commission alleged that interest rates or currency values indirectly affected crude oil prices.

conflicting requirements on futures market participants, but its proposal would contradict the CEA in multiple ways. Under the CEA, price manipulation constitutes acting with specific intent to create an artificial price. The Commission could have adopted the same formulation for its proposed price manipulation prohibition, but chose not to do so. Instead, the Commission decided to propose a rule following the SEC Rule 10b-5 template, resulting in a prohibition that contradicts the CEA by eschewing as elements of a violation both specific intent and artificial price effects. 73 Fed. Reg. 48328 and 48329. In fact, the Commission does not even use the word manipulation in its prohibition.

Under the Commission's proposed rule, any person would violate the anti-deception and anti-manipulation provisions of Section 811 of EISA by buying or selling wholesale crude oil, gasoline or petroleum distillates when such person recklessly (not with specific intent) --

> "a) uses or employs any device to defraud;
>
> b) makes any untrue statement of a material fact or omits to state a material fact necessary to make prior statements made in light of the circumstances under which they were made not misleading; or
>
> c) engages in any act, practice or course of business that operates or would operate as a fraud or deceit upon any person."

Proposed Rule 317.3

The rejection by the Commission of the specific intent standard as part of its proposed Rule contradicts CFTC jurisprudence and imposes a significant threat to the proper functioning of the U.S. futures markets in crude oil and gasoline. When the CFTC was asked years ago to consider abandoning the specific intent standard as the required *mens rea* for finding manipulation, the CFTC responded that it was "unable to discern any justification for a weakening of the manipulative intent standard which does not wreak havoc with the market place." *In the Matter of Indiana Farm Bureau* CFTC No. 75-14, 1982 WL 30249 * 5. If the

Commission's proposed Rule 317.3 is to be applied to futures (which would be both unauthorized and unwise) at least the Commission should defer to the CFTC's expert views on the scienter element for manipulation as applied to the specialized needs of the futures marketplace.

Similarly, the Commission contradicts legal standards developed under the CEA when it proposes to find a respondent to have committed price manipulation without requiring any proof of a price effect, what CEA jurisprudence calls "price artificiality." 73 Fed. Reg. at 48329. In order to prove a futures price manipulation, the CFTC must show that the defendants conduct created an artificial price or, in an attempt case, constituted an attempt to create an artificial price. In an action to enforce proposed Rule 317.3, the Commission claims it would not need to prove that a defendant's conduct had any effect on price "identifiable price effects before such conduct is culpable." 73 Fed. Reg. at 48329. To the extent proposed Rule 317.3 would prohibit conduct that did not create or attempt to create an artificial futures price, it would directly contradict the CEA.[10] Thus, the Commission's proposed Rule 317.3 conflicts with both the specific intent and artificial price elements of futures market price manipulation under the CEA. These contradictions will be difficult for market participants to reconcile.

If applied to futures trading, the Commission's rule also would contradict the principal antifraud provision of the CEA, which Congress amended and re-enacted last spring in Section

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[10] The CEA also prohibits false reporting: it is unlawful for any person "knowingly to deliver or cause to be delivered for transmission through the mails or interstate commerce by telegraph, telephone, wireless, or other means of communication false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce …." 7 U.S.C. § 13(a)(2). To the extent that CEA false reporting prohibition requires a showing that the false report "affects or tends to affect the price of any commodity in interstate commerce" and the Commission's proposed Rule requires no showing of price effect, another potential conflict arises with the CEA and the Commission's proposal. We would urge the Commission to adopt the CEA's false reporting legal standard to avoid creating confusion and uncertainty in the market place.

13102 of the 2008 Farm Bill.[11] Section 4b embodies certain carefully-crafted limitations on its scope, limitations which the Commission's proposed Rule 317.3 plainly lacks. Therefore the Commission's proposed Rule also contradicts CEA § 4b.

Section 4b makes it unlawful for any person in connection with a futures contract:

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[11] Under Public Law No. 110-246, 122 Stat. 2194-95 (2008), Section 4b of the CEA will now read:

"(a) Unlawful Actions. - It shall be unlawful -

(1) for any person, in or in connection with any order to make, or the making of, any contract of sale or any commodity in interstate commerce or for future delivery that is made, or to be made, on or subject to the rules of a designated contract market, for or on behalf of any other person; or

(2) for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery, or other agreement, contract, or transaction subject to paragraphs (1) and (2) of section 5a(g), that is made, or to be made, for or on behalf of, or with, any other person, other than on or subject to the rules of a designated contract market -

(A) to cheat or defraud or attempt to cheat or defraud the other person;

(B) willfully to make or cause to be made to the other person any false report or statement or willfully to enter or cause to be entered for the other person any false record;

(C) willfully to deceive or attempt to deceive the other person by any means whatsoever in regard to any order or contract or the disposition or execution of any order or contract, or in regard to any act of agency performed, with respect to any order or contract for or, in the case of paragraph (2), with the other person; or

(D)(i) to bucket an order if the order is either represented by the person as an order to be executed, or is required to be executed, on or subject to the rules of a designated contract market; or

(ii) to fill an order by offset against the order or orders of any other person, or willfully and knowingly and without the prior consent of the other person to become the buyer in respect to any selling order of the other person, or become the seller in respect to any buyer order of the other person, if the order is either represented by the person as an order to be executed, or is required to be executed, on or subject to the rules of a designated contract market unless the order is executed in accordance with the rules of the designated contract market.

(b) Clarification - Subsection (a)(2) of this section shall not obligate any person, in or in connection with a transaction in a contract of sale of a commodity for future delivery, or other agreement, contract or transaction subject to paragraphs (1) and (2) of section 5a(g), with another person, to disclose to the other person nonpublic information that may be material to the market price, rate or level of the commodity or 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."

> "(A) to cheat or defraud or attempt to cheat or defraud the other person;
>
> (B) willfully to make or cause to be made to the other person any false report or statement or willfully to enter or cause to be entered for the other person any false record;
>
> (C) willfully to deceive or attempt to deceive the other person by an means whatsoever in regard to any order or contract or the disposition or execution of any order or contract, or in regard to any act of agency performed, with respect to any order or contract for or, in the case of paragraph (2), with the other person ...."
>
> 122 Stat. 2194-95.

When compared to the three prohibitions in proposed Rule 317. 3, the overlap is apparent. Both cover actions that defraud or deceive, as well as making false statements. In at least one respect, the actual prohibitions in Section 4b are even broader, as they expressly cover attempts to defraud or deceive.[12]

But Section 4b contains two limitations that are absent from proposed Rule 317.3. First, for trading in cash commodities and futures on regulated exchanges called "contract markets,"[13] Section 4b's prohibitions apply only to those acting as *intermediaries or agents*, or "for or on behalf of" the party being defrauded or deceived. See CEA § 4b(1). See *Commodity Trend Serv. Inc. vs. CFTC*, 233 F.3d 981, 991-992 (7th Cir 2000). Second, for all other futures trading,

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[12] Section 4b as amended also echoes another aspect of the Commission's proposal insofar as it makes clear that Congress does not intend any affirmative disclosure obligation to apply to futures trading (as in the abstain or disclose insider trading principle embraced in securities regulation). Section 4b states 122 Stat 2195:

"(b) Clarification - Subsection (a)(2) of this section shall not obligate any person, in or in connection with a transaction in a contract of sale of a commodity for future delivery, or other agreement, contract or transaction subject to paragraphs (1) and (2) of section 5a(g), with another person, to disclose to the other person nonpublic information that may be material to the market price, rate or level of the commodity or 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."

[13] The CME, CBOT, NYMEX, COMEX and ICE Futures US are each contract markets under the CEA.

Section 4b's prohibitions apply only to those acting as *intermediaries or agents,* or "for or on behalf of," or as *counterparties* to, what the statute describes as making a contract "with," the party being defrauded or deceived. See CEA § 4b(2).

Neither limit is found in proposed Rule 317.3. While Section 4b prohibits only agents from defrauding their principals, and, in off-exchange futures, the buyer from defrauding the seller (or vice versa,), proposed Rule 317.3 would apply to any futures market participant that defrauds or deceives any other futures market participant (or even someone in another market) whatever their legal relationship or lack thereof. In the CEA, however, Congress limited the reach of the antifraud provision to agents and principals, those in contractual privity with the defrauded party. Proposed Rule 317.3 would override the limitations Congress has imposed and contradict the CEA's most recently enacted provisions. It is doubtful that Congress last June would have enacted, or re-enacted, these limitations in CEA § 4b if Congress understood that EISA would be interpreted to allow the Commission to erase these limitations for some futures trading.

To avoid the "contradictory requirements" the Commission stated it intended to avoid, the Futures Group reiterates its request that the Commission adopt a safe harbor from Rule 317.3 for persons engaged in futures trading activities and covered by the CFTC's exclusive jurisdiction. In the alternative, the Commission could specify that futures market participants are subject only to the provisions of Section 4b of the CEA, as well as the anti-manipulation provisions of the CEA in Sections 6(c), 6(d) and 9(a)(2) of the CEA, 7 U.S.C. §§ 9, 13b, and 13(a)(2), and consistent with the CEA's exclusive jurisdiction provision in 7 U.S.C. § 2(a)(1)(A), only the CFTC may enforce those provisions. Either approach would be consistent with the Congress' goals as reflected in the CEA's exclusive jurisdiction provision and the goal of the

Commission to avoid contradictory requirements for those trading and conducting business in the futures markets.

Conclusion.

The changes requested by the Futures Group do not seek to weaken the ability of the Commission to eliminate market manipulation where the Commission has jurisdiction. Price manipulation is corrosive to any market, and especially to the price discovery, price dissemination and hedging functions futures markets are designed to perform. We therefore applaud the efforts of the Commission to pursue manipulative and deceptive practices in markets falling outside the purview of the CFTC's exclusive jurisdiction. But attempting to impose an additional layer of regulation on futures markets and abandoning well-settled principles of futures manipulation doctrine are not authorized by law, and would operate to harm substantially the U.S. energy futures and related markets. We would be pleased to answer any questions the Commission may have about the subjects discussed in this letter.

Sincerely,

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ATTACHMENT

Commodity Exchange Act Exclusive Jurisdiction Provision
7 U.S.C. § 2(a)(1)(A) as amended by Pub. L. No. 110-246,
122 Stat. 1651, 2201 (June 18, 2008)

(A) IN GENERAL.--The Commission shall have exclusive jurisdiction, except to the extent otherwise provided in subparagraphs (C) and (D) of this paragraph and subsections (c) through (i) of this section, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery (including significant price discovery contracts), traded or executed on a contract market designated or derivatives transaction execution facility registered pursuant to section 5 or 5a or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 19 of this Act. Except as hereinabove provided, nothing contained in this section shall (I) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (II) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State.

Case Studies:

Recent Legislative and Regulatory Developments in Response to Changes in Natural Gas Markets

BY BRIAN J. REGAN AND DE'ANA H. DOW

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Introduction

The Commodity Futures Modernization Act of 2000 (CFMA), landmark legislation that substantially amended the Commodity Exchange Act (CEA), ushered in significant changes to the regulatory landscape for futures trading. Over the last year, the continuing surge in the prices for crude oil and for crude products such as gasoline has led to the current focus on Capitol Hill on a number of bills that have been introduced or proposed that would establish additional federal regulation of energy markets as a response to this price run-up. Yet, only a few short months ago, Congressional focus was largely upon natural gas trading, particularly with regard to the interaction between trading on over-the-counter (OTC) venues and trading on regulated exchanges.

A number of the initiatives now being proposed in response to high crude prices are quite sweeping in nature and purportedly are responding to the role of speculators in energy markets. However, there is a real dearth of data to support such sweeping changes. Indeed, a careful review of data made available by the Commodity Futures Trading Commission (CFTC) on its website generated from large trader reports filed with the CFTC provides strong contrary evidence that speculators are not directly influencing crude prices. Furthermore, most serious economists acknowledge that, as a result of the convergence of physically settled futures contracts and other market characteristics, crude futures prices are primarily being determined by supply-demand fundamentals in the far larger market for the physical cash commodity.

The recent Congressional response to evolution in natural gas markets may be viewed as a useful case study of an instance when Congress got it right. Specifically, the recent CFTC reauthorization shows how Congress can analyze public policy issues and then fashion appropriate statutory responses that provide thoughtful and targeted solutions to an identified problem. Perhaps Congress will find a way to follow its recent practice once there has been time to digest and assess the initial flurry of proposed responses to high oil prices.

On the regulatory front, the ongoing exercise by the Federal Energy Regulatory Commission (FERC) of its new authority provides a contrasting case study of a situation in which a federal regulatory agency has undertaken actions where arguably the public interest costs outweigh the benefits. FERC's mishandling of its relatively new authority may prove to be instructive to other agencies in the event that Congress continues to grant new authority regarding energy markets to federal agencies other than the CFTC. Thus, for example, the comment period recently closed on an Advance Notice of Proposed Rulemaking recently issued by the Federal Trade Commission on the implementation of Section 811 of the Energy Independence and Security Act of 2007.

Energy Market Regulation

Under the CFMA amendments to the CEA, energy commodities are classified as exempt commodities.[1] Consequently, among other choices, energy commodities can be traded on regulated exchanges, known as Designated Contract Markets (DCMs), or OTC on electronic trading platforms, known as Exempt Commercial Markets (ECMs), or through voice brokers. This tiered approach, which provides various options (some regulated, some not) for the listing of energy commodities for trading, has proven effective, and as anticipated, has brought healthy competition and tremendous growth to energy derivatives trading.

DCMs are fully regulated by the Commodity Futures Trading Commission (CFTC), which has exclusive jurisdiction over futures contracts, trading and markets under the CEA. In addition to the CFTC's own direct monitoring of futures trading, DCMs have an affirmative statutory obligation to act as self-regulatory organizations (SROs), subject to the standards set by the CEA and by CFTC regulation and interpretation. As an SRO, DCMs routinely use tools such as large trader reporting and position limits and position accountability levels to monitor and police trading.

Following the adoption of amendments to the CFMA, the CFTC implemented regulations for new statutory tiers of trading facilities that included the ECM. The ECM as originally structured was essentially exempt from substantive CFTC regulation and also had no explicit SRO duties by statute. Derivatives markets subsequently evolved in ways that were not anticipated in 2000 when the CFMA was enacted, such as the effective linking of trading on unregulated venues with trading on regulated venues of certain competing products. As a result of this linkage, certain ECM contracts began to serve in a price discovery role and thus triggered public policy concerns by Congress that ultimately warranted a higher degree of CFTC oversight and regulation.

A CFTC report to Congress recommended that such contracts be subject by statute to large trader reporting, position limits or position accountability levels, self-regulatory oversight obligations, and emergency authority for both the CFTC and for the ECM itself.[2] The CFTC's recommended changes subsequently were also supported by the President's Working Group on Financial Markets.[3] Congress passed the CFTC Reauthorization Act of 2008 as an amendment to the Farm Bill on May 22, 2008. The provisions of the new law pertaining to ECMs is found in Title XIII, Subtitle B of the Farm Bill and is entitled Significant Price Discovery Contracts on Exempt Commercial Markets. The provisions contained in subtitle B specifically address the situation in which an ECM becomes a price discovery market and becomes linked to a regulated exchange.

Role and Responsibilities of a DCM

Unlike securities markets, which serve an essential role in capital formation, organized derivatives venues, such as the New York Mercantile Exchange, Inc. (NYMEX or Exchange), can be viewed as providing an economic benefit to the public by serving two key functions: (1) competitive price discovery; and (2) hedging by market participants. A CFTC glossary of standard industry terms informally defines hedging as follows:

> **"[t]aking a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change; or a purchase or sale of futures as a temporary substitute for a cash transaction that will occur later. One can hedge either a long cash market position (e.g., one owns the cash commodity) or a short cash market position (e.g., one plans on buying the cash commodity in the future)."**

As a result of the CFMA, which substantially modified the CEA, a DCM generally must comply with a number of flexible, performance-based Core Principles and is fully subject to the CFTC's regulation and oversight. These include eight

Core Principles that constitute initial designation criteria,[4] as well as 18 other ongoing Core Principles for DCMs.[5] In addition to the terms of the Core Principles, the CFTC has published application guidance on compliance with the Designation Criteria (17 C.F.R. § 38 Appendix A) and Guidance on, and Acceptable Practices in Compliance with Core Principles. (17 C.F.R. § 38 Appendix B). The guidance for each Core Principle is illustrative of the types of matters a DCM may address, as applicable, and is not intended to be used as a mandatory checklist.

The CFMA explicitly provides that the board of trade, i.e., DCM, "shall have reasonable discretion in establishing the manner in which it complies with the core principles." (CEA Section 5(d) (1)). The DCM's ability to respond as needed to rapidly changing markets by amending existing contract specifications and introducing new risk management contracts has benefited markets and market participants significantly. In addition, as intended, the adoption of a flexible Core Principles approach to commodity market regulation has enabled futures markets to compete with OTC and foreign markets and has facilitated phenomenal growth in the futures industry.

Under the CEA, a DCM has an affirmative statutory obligation to act as an SRO. In this connection, it is worth noting that the history of self-regulation by futures exchanges long predates the implementation of federal regulation of such markets. Indeed, self-regulatory duties were voluntarily assumed by futures exchanges not long after their inception and have been maintained over the years as a hallmark of U.S. commodity markets.

An SRO must police its own markets and maintain a program that establishes and enforces rules related to detecting and deterring abusive practices. Of particular note is the series of Core Principles that pertain to markets and to market surveillance. Thus, a DCM can list for trading only those contracts that are not readily susceptible to manipulation. In addition, a DCM must monitor trading to prevent manipulation, price distortion and disruptions of the delivery or cash-settlement process. Furthermore, to reduce the potential threat of market manipulation or congestion, the DCM must adopt position limits or position accountability levels for a listed contract, where necessary or appropriate.

The principal tool that is used by DCMs to monitor trading for purposes of market integrity is the large trader reporting system. At NYMEX, for example, the reportable position levels are distinct for each energy contract listed for trading. The levels are set by the Exchange and are specified by rule amendments that are submitted to the CFTC, following consultation and coordination with the CFTC staff.

For example, the reportable position level for the physically delivered NYMEX natural gas futures contract (which is referenced by the NYMEX commodity code NG), is currently 200 contracts. NYMEX Market Surveillance staff routinely reviews price activity in both futures and cash markets, focusing, among other things, on whether the futures market price is converging with the spot physical market price as the NYMEX contract nears expiration. Large trader data are reviewed daily to monitor customer positions in the market. Specifically, on a daily basis, NYMEX collects the identities of all participants who maintain open positions that exceed set reporting levels as of the close of business the prior day. These data are used to identify position concentrations requiring further review and focus by Exchange staff. These data are collected by the CFTC and are also published in aggregate form for public view on the CFTC website in a weekly Commitments of Traders (COT) report.

By rule, DCMs also maintain and enforce limits on the size of positions that any one market participant may hold in a listed contract. These limits are set at a level that greatly restricts the opportunity to engage in possible manipulative activity on a DCM. Futures markets traditionally list futures and options contracts as a series of calendar contract months. For example, in an expiring contract month in which trading is terminating, NYMEX uses a hard expiration position limit (i.e., NG at 1,000 contracts). For back months of the NG futures contract, NYMEX currently maintains an any–one- month accountability level of 7,000 contracts and an all-months-combined position accountability level of 12,000 contracts. When position accountability levels are exceeded, Exchange staff conducts heightened review and may inquire into the nature of the position, which ultimately may result in NYMEX staff directing the market participant to reduce its positions. Breaching the position limit can result in disciplinary action by the Exchange. Finally, NYMEX also maintains a program that allows for certain market participants to apply for hedge exemptions from the position limits in place on expiring contracts. Such hedge exemptions are granted on a case-by-case basis following adequate demonstration of *bona fide* hedging activity involving the underlying physical cash commodity or related swap agreements.

Statutory Changes in 2000

The CFMA, adopted in December 2000, streamlined and modernized the regulatory structure of the derivatives industry. It provided legal certainty for OTC swap transactions by creating new exclusions and exemptions from substantive CFTC regulation for bilateral transactions between entities, institutions and/or high net-worth participants in financial derivatives and in exempt commodity derivatives, such as energy and metals.

The CFMA also permitted bilateral trading of energy on electronic trading platforms. Under CFTC rules, these electronic trading platforms are called "exempt commercial markets" with transactions on such venues subject only to the CFTC's antifraud and anti-manipulation authority. Unlike a DCM, an ECM under the CFMA is treated as an exempt market and consequently not directly regulated by the CFTC. In addition, the original form of an ECM had no express statutory self-regulatory obligations to monitor its own markets. However, unlike the regulated futures exchanges, which voluntarily assumed self-regulatory obligations long before such responsibilities were codified in federal law, ECMs generally, have not assumed such duties on a voluntary basis. Thus, it was left up to Congress to mandate such duties where appropriate through legislative action.

Beyond the absence of any general or overarching SRO duties, ECMs additionally were not required originally to maintain any surveillance systems or programs to monitor activity on their markets to ensure the integrity of products listed on their trading venues. Therefore, ECMs were neither utilizing tools to identify market participants who maintain large positions in their listed products nor were they restricting or monitoring the size of open positions that may be maintained in their products.

The derivatives industry embraced the CFMA at the time of its passage as a landmark piece of legislation, and overall it has continued to be quite effective in allowing the CFTC to keep pace with very complex and dynamic financial markets. However, with an ever-evolving market place, today's markets differ dramatically from only seven years ago, which resulted in Congressional reevaluation of certain aspects of the CFMA. Due to the changes in the market place, Congress ultimately concluded that non-regulation of certain ECM contracts could no longer be reasonably justified.

Most notably, a series of profound changes occurred in the natural gas market since the passage of the CFMA, including technological advances in trading. As a result of those changes, a regulated DCM, NYMEX, and an unregulated ECM, Intercontinental Exchange (ICE), became highly linked trading venues. This phenomenon could not have been reasonably foreseen a few short years ago and, consequently, the original statutory structure of the CFMA no longer worked adequately for certain markets now operating as ECMs. The regulatory disparity between NYMEX and certain ECMs created serious challenges for the CFTC, as well as for NYMEX in its capacity as an SRO. In particular, the development of arbitrage activity between NYMEX and ICE essentially caused the venues to become linked and to serve the same economic functions.

When the CFTC was in the midst of proposing and finalizing the implementation of regulations and interpretations for the CFMA, the natural gas market continued to be largely focused upon open outcry trading executed on the regulated NYMEX trading venue. At that time, NYMEX offered electronic trading on an "after-hours" basis, which contributed only approximately 7-

10% of overall trading volume at the Exchange, at best a modest proportion of the overall market. Moreover, it was more than six months following the Enron financial meltdown before the industry began to offer clearing services for OTC natural gas transactions.

In determining to compete with NYMEX, ICE duplicated or copied product terms of NYMEX's core natural gas futures contract, and also arguably appropriated the NYMEX settlement price for daily and final settlement of its own contracts. Thus, for some period of time, natural gas market participants have had the assurance that they could receive the benefits of obtaining NYMEX's settlement price, which is viewed by many as the pricing benchmark, by engaging in trading either on NYMEX or ICE.

For some time, ICE was the only trading platform that offered active electronic trading during daytime trading hours. In September of 2006, NYMEX began providing "side-by-side" trading of its products -- listing products for trading simultaneously on the trading floor via open-outcry and on the electronic screen. Since that time, there has been active daytime electronic trading of natural gas on both NYMEX and ICE. The share of electronic trading at NYMEX as a percentage of overall transaction volume at the Exchange has increased dramatically to the extent that electronic trading now accounts for a substantial percentage of NYMEX's overall trading volume. The existence of daytime electronic trading on both NYMEX and ICE has fueled the growth of arbitrage trading between the two markets.

Thus, a number of market participants that specialize in arbitrage activity have established computer programs for electronic trading that automatically transmit orders to one venue when there is an apparent price imbalance with the other venue or where one venue is perceived to offer a better price than the other. As a result, there has been a relatively consistent and tight spread in the prices of the competing natural gas products. Hence, the two competing trading venues are now tightly linked and highly interactive as two components of a broader derivatives market. No one could have predicted how this market would have evolved when the exemption was crafted for energy swaps in 2000.

In addition to the perceived appropriation of NYMEX's settlement price, ICE now has a significant market share of natural gas trading, and a number of observers have indicated that most of this trading in the ICE Henry Hub swap is subsequently cleared by the London Clearing House, the organization that has been contracted by ICE to provide clearing services.[6] Thus, there is now a concentration of market activity occurring on the ICE trading venue as well as the exchange-like concentration and mutualization of financial risk at the clearing house level from that activity.

Impact on DCM from Lack of Regulation of Linked Exchanges

As a DCM, NYMEX experienced first-hand how this regulatory disparity operated in the failure of Amaranth, which operated a seven billion dollar hedge fund that was active in the NG contract. In August of 2006, NYMEX proactively took steps to maintain the integrity of its contracts by ordering Amaranth to reduce its open positions in the natural gas futures contract. Amaranth reduced its NYMEX position but sharply increased its positions on the ICE electronic trading platform. Because the ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive, Amaranth's response to NYMEX's regulatory directive admittedly reduced its positions on NYMEX but did not reduce Amaranth's overall market risk or the risk of Amaranth's guaranteeing clearing member. Furthermore, the integrity of NYMEX markets continued to be affected by and exposed to Amaranth's outsize positions in the natural gas market. Unfortunately, neither NYMEX nor the CFTC had an efficient means at that time to monitor Amaranth's positions on ICE or to take steps to have Amaranth reduce its participation in that unregulated trading venue.

Because ICE price data are available only to its market participants, NYMEX does not have the means to establish conclusively the extent to which trading of ICE natural gas swaps contributes to, influences or affects the price of the related natural gas contracts on NYMEX. However, what is clear is that as a consequence of the extensive arbitrage activity between the two platforms and ICE's use of NYMEX's settlement price, the two natural gas trading venues, as noted above, are now tightly linked and highly interactive. During most of the trading cycle of a listed futures contract month, there has been a range of approximately only five to twelve ticks separating the competing NYMEX and ICE products (the NYMEX NG contract has a minimum price fluctuation or trading tick of $.001, or .01 cents per mmBtu). These two trading venues serve the same economic functions and, therefore, are now functionally equivalent.

Also, market participants who trade on both markets have stated that a rise or fall in price on one trading venue will be followed almost immediately by a rise or fall in price on the other trading venue, whether the change in price is initiated on either NYMEX or ICE. These observations of real-world market activity support the conclusion that trading of ICE natural gas swaps do in fact contribute to, influence and affect the price of the related natural gas contracts on NYMEX.

In June of last year, the U.S. Senate's Permanent Subcommittee on Investigations (PSI) issued a report on "Excessive Speculation in the Natural Gas Market" (PSI Report).[7] The PSI investigation was in direct response to the collapse of Amaranth. The observations noted above were essentially accepted by the PSI Report. These observations were also supported by the research conclusions contained in an October 24, 2007 CFTC report to Congress.

Specifically, as part of the October 24 report to Congress, the Commission's Office of the Chief Economist (OCE) conducted an empirical study of the relationship of the natural gas contracts that trade on ICE and on NYMEX.[8] OCE evaluated price discovery in the natural gas market, viewing price discovery as the manner by which new information was incorporated into the market price. OCE collected transaction price data for ICE and NYMEX natural gas contracts from January 3, 2006 through December 31, 2006 and evaluated trading for 20 contract months during that period. OCE concluded that, in an economic sense, ICE and NYMEX are both significant price discovery venues for natural gas futures contracts

ICE and NYMEX compete with each other and there are currently no arrangements in place (such as information-sharing) to address market integrity issues. As previously stated, NYMEX, as a DCM, has affirmative self-regulatory obligations; as an ECM, ICE originally had no such duties. Yet, from a market perspective, the ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive such that trading activity and price movement on one venue can quickly affect and influence price movement on the other venue.

In connection with the Exchange's ongoing routine market surveillance programs and in conjunction with procedures that were previously described, NYMEX staff was aware of and monitored all open positions that Amaranth maintained in NYMEX trading venues, including the physically delivered natural gas futures contract. NYMEX conducted regular reviews of Amaranth's open positions in excess of applicable position accountability levels. Various other contracts that NYMEX offers, such as American and European options on natural gas, along with other various futures contracts, are aggregated into the NG contract for monitoring accountability levels on a futures equivalent basis.

As previously stated, NYMEX staff members directed Amaranth in early August 2006 to reduce its open positions in the first two nearby contract months based upon what they believed to be a significant concentration in NYMEX markets in natural gas. As a consequence, a shift of positions by Amaranth from NYMEX to ICE was undetectable both by NYMEX and the CFTC.

NYMEX is not supplied position data regarding other venues on a regular basis by either market participants or other trading venues (such as ICE or other OTC platforms). However, by rule, NYMEX has broad authority to request and to be supplied "information" with respect to a position in excess of the prescribed accountability levels. NYMEX gathered information regarding expiring contracts in the process of approving hedge exemptions subject to NYMEX Rule 9.26

for Amaranth where they represented offsetting exposure.

CFTC Report

By letter dated October 24, 2007, the CFTC, as noted above, delivered to Congress a report that included recommendations to increase the oversight of some trading activity on electronic trading facilities.[9] According to the CFTC, their report was designed to provide recommendations "to strike a balance between the appropriate level of market oversight and transparency while promoting market innovation and competition to ensure that these markets remain on U.S. soil." The CFTC report was developed in consultation with the President's Working Group on Financial Markets. The Commission's legislative recommendations included establishing the following for certain ECM contracts that serve a significant price discovery function:

1. **Large Trader Position Reporting** – comparable to reporting requirements that currently apply to contracts traded on regulated exchanges;
2. **Position Limits and/or Accountability Level Regime** – comparable to those that currently apply to similar contracts traded on regulated exchanges;
3. **Self-Regulatory Oversight** – designed to detect and prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process; and
4. **Emergency Authority** – to prevent manipulation and disruptions of the delivery or cash-settlement process.

Beyond the legislative changes proposed, the Commission also announced its intention "to: (1) establish an Energy Markets Advisory Committee to conduct public meetings on issues affecting energy producers, distributors, market users and consumers; and (2) work closely with the FERC to educate and develop best practices for utilities and others who use NYMEX settlement prices as hedging vehicles and benchmarks in pricing their energy products."[10]

Following the release of the CFTC report, a consensus began to develop in the derivatives industry that regulatory reform was necessary in order to promote transparent, fair and orderly markets, and the Commission's report validates this approach. ECM contracts that serve a significant price discovery function trigger a number of public policy concerns and warrant a higher degree of CFTC oversight and regulation. These contracts should be subject to large trader reporting, position limits or position accountability, self-regulatory oversight obligations, and emergency authority for both the CFTC and for the ECM itself. These mechanisms enable NYMEX to provide market integrity and stability to the energy futures markets.

Following transmission of the CFTC's report to Congress, Senator Mike Crapo, by letter dated October 30, 2007, requested the views of the PWG on the CFTC report and its recommendations. The PWG, as noted previously, responded in an undated letter to Senator Crapo and expressed its support for the CFTC's recommended legislative changes. The PWG also noted its belief that the CFTC proposal "strikes the appropriate balance between protecting consumers and markets from trading abuse while ensuring continuing growth and innovation in the U.S. markets." Indeed, there was eventually a broad consensus for increased transparency and CFTC oversight of significant price discovery contracts (SPDC). In December 2007, the full Senate and the House Agriculture Committee passed CFTC reauthorization legislation that included provisions to address linked market issues identified by the CFTC, the Senate PSI Committee, and NYMEX. Specifically, an SPDC would be subject to eight Core Principles, including position limits and large trader reporting requirements. Additionally, the electronic trading platform listing SPDCs would be required to perform self-regulatory functions to ensure compliance with the Core Principles. These provisions ultimately were passed into law as part of the CFTC reauthorization.

CFTC Reauthorization

On May 22, 2008, Congress enacted amendments to the CEA as one title of the comprehensive Farm Bill, cited as the "CFTC Reauthorization Act of 2008" found in Title XIII – Commodity Futures.[11] Congress responded to the public policy concerns that had been raised by passing into law targeted and carefully crafted approach to a serious regulatory gap. The amendments to the CEA, among other things, define and establish standards for SPDCs. Under the amendments, SPDC is defined in Section 1a (33) of the CEA as an agreement, contract, or transaction subject to Section 2(h) (7). Section 2(h) is amended to establish a regulatory framework for SPDCs, including nine Core Principles. Specifically, an electronic trading facility on which SPDCs are traded or executed must comply with the following core principles:

- List only SPDCs that are not readily susceptible to manipulation;
- Monitor trading to prevent manipulation, price distortion and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and disciplinary practices and procedures;
- Establish and enforce rules that allow the trading facility to obtain necessary information to perform its self-regulatory functions;
- Adopt position limitations or position accountability for speculators in SPDCs to reduce the potential threat of market manipulation or congestion;
- Adopt rules to provide for the exercise of emergency authority, in consultation and cooperation with the CFTC, including the authority to liquidate open positions and to suspend or curtail trading in an SPDC;
- Make public daily information on price, trading volume and other trading data;
- Monitor and enforce compliance with any rules of the trading facility, including the terms and conditions of the contracts and any limitations on access to the trading facility;
- Establish and enforce rules to minimize conflicts of interest; and
- Avoid adopting any rules or taking any actions that result in any unreasonable restraints of trade or imposing any material anticompetitive burden on trading on the trading facility.

CFTC-FERC Jurisdiction

Section 2(a)(1) of the Commodity Exchange Act provides that "[t]he Commission shall have *exclusive jurisdiction ... with respect* to accounts, agreements ... , and *transactions involving contracts of sale of a commodity for futures delivery, traded or executed on a [designated contract market* or derivatives transaction execution facility] ..." (emphasis added). This statutory grant of exclusive jurisdiction to the CFTC is unequivocal on its face. It embodies the clear intent of Congress to vest sole authority in one expert agency. This well-reasoned and wise decision of Congress must be upheld. To allow FERC or any other federal agency to interpret its authority so broadly that it nullifies the plain meaning of the language would conflict with the clear Congressional intent. The resulting untended consequences will cause grave harm to the markets, consumers and the U.S. economy.

The Energy Policy Act of 2005 (EPAct) granted FERC new anti-manipulation authority. At the same time, the EPAct directed that FERC establish a memorandum of understanding with the CFTC to work together in cooperation and to share information. In that memorandum of understanding, the FERC specifically conceded and acknowledged that the CFTC: "has **exclusive** jurisdiction with respect to accounts, agreements, and transactions involving contracts of sale of a commodity for future delivery. . . " (emphasis added). More recently, however, FERC has broadly interpreted its authority to extend to NYMEX natural gas futures transactions because many of FERC's jurisdictional entities use the NYMEX settlement price as a benchmark for their spot market pricing. The CFTC and FERC are now both exercising authority over the same conduct under different standards. The legal and practical arguments against this outcome are addressed below.

Statutory interpretation and legislative history provide legal support for preserving the CFTC's exclusive jurisdiction. These points are made clearly and persuasively in an amicus brief filed by several major futures industry organizations in support of CFTC exclusive jurisdiction and Defendant Amaranth Advisors' stay motion filed in the U.S. District Court for the Southern District of New York. A brief overview of some of those arguments follows.

First, exclusive jurisdiction was intended to make the CEA and CFTC regulations the sole legal and regulatory requirements for futures markets and trading thereon. Congress established exclusive jurisdiction under the CEA to avoid legal uncertainty and the related market confusion and economic cost. The operation and competitiveness of U.S. futures markets are best served by one body of law applied exclusively to futures markets and trading. It ensures a cohesive and well-reasoned regime that provides financial and market integrity and ensures the legal certainty needed for the continued growth and competitiveness of U.S. futures markets. The FERC itself once found that Congress intended the CEA's exclusive jurisdiction provision "to give a single expert agency [the CFTC] the responsibility for developing a coherent regulatory program for the commodities industry and to prevent the costs and confusion associated with multiple regulators."[12]

Second, "jurisdiction ... with respect to ... transactions involving" futures contracts – reasonably includes jurisdiction over an order to buy or sell, as well as the buying and selling of a futures contract. In fact, all trading conduct and misconduct, such as futures price manipulation, is covered by the terms "with respect to" and "involving" orders to buy and sell futures contracts and is therefore under the CFTC's exclusive jurisdiction. Any other interpretation would contradict the plain meaning of the statute and the clear intent of Congress.

Third, Congress did not create an exception to CFTC exclusive jurisdiction in 2005. Historically, when Congress has limited the CFTC's exclusive jurisdiction relative to particular products, it has done so explicitly through amendments to Section 2(a)(1)(A). To date, the limitations on the CFTC's exclusive jurisdiction apply to securities related products subject to the SEC's authority and not to energy products. If Congress intended to carve out a portion of the CFTC's jurisdiction to give to FERC, it is reasonable to expect that it would have expressly done so, as in the past. Furthermore, to provide an exception to the CFTC's exclusive jurisdiction in the context of the Energy Policy Act of 2005, in effect, would undermine the purpose of the grant of exclusive jurisdiction in the CEA. This outcome would be wholly inconsistent with the rules of statutory interpretation.

Finally, the legislative history unequivocally affirms the scope of the CFTC's exclusive jurisdiction. Congress enacted exclusive jurisdiction in the Commodity Futures Trading Commission Act of 1974. The Conference Committee, in reconciling the differing House and Senate versions of the pending bill's exclusive jurisdiction provisions, decided the House version was too ambiguous, and adopted the Senate's provision to ensure the exclusivity of the Commission's jurisdiction over futures contract markets and to ensure that the Commission's jurisdiction, where applicable, supersedes State as well as Federal agencies." (Conf Rep at 35; S. Rep. at 6). The Conference Committee further explained that "under the exclusive grant of jurisdiction to the Commission, the authority of the Commodity Exchange Act (and regulations issued by the Commission) would preempt the field insofar as futures regulation is concerned." (Conf. Rep. at 35.)

Congress intended the CFTC Act of 1974 to strengthen futures regulation, create a comprehensive regulatory structure for futures trading, and avoid regulatory gaps. Further, Congress intended that the new agency be an expert in futures regulation – a function which requires highly specialized skills. Consequently, the CFTC has developed into an expert in futures market oversight and the agency effectively carries out its statutory mandate "to deter and prevent price manipulation or any other disruptions to market integrity" (Section 3 of the CEA). This well-reasoned and successful approach to regulation of futures markets is now threatened by dueling regulators. The CFTC and FERC have different statutory mandates. The authority that FERC claims under its new manipulation mandate cannot co-exist with the CFTC's exercise of its exclusive jurisdiction over futures markets and transactions.

This reality was made clear in the recent enforcement actions brought under different standards for manipulation by both regulators against Amaranth Advisors for trading activity occurring on NYMEX. The statutory authorities under which FERC and CFTC operate with respect to preventing manipulation of the spot and futures markets differ significantly. FERC derives its authority from section 315 of the Energy Policy Act of 2005, which gives them manipulation authority over "any entity" that commits manipulation, directly or indirectly, in connection with FERC-jurisdictional transactions. FERC broadly interprets this new authority to include the ability to bring enforcement action on futures exchange activity, which is under the CFTC's exclusive jurisdiction. In developing the rule, FERC drew heavily from the Securities and Exchange Commission's rule 10b-5, under which the Supreme Court has defined manipulation as conduct "designed to deceive or defraud investors by *controlling or artificially affecting* the price of securities" or practices that "artificially affect market activity."

On the other hand, the CFTC's anti-manipulation authority is derived from Section 9(a) of the Commodity Exchange Act. It provides that it is a felony to ". . . manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity or knowingly to deliver or cause to be delivered . . . false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce . . . ."

Having two different standards for manipulation targeting the same trading activity and being enforced by two different federal agencies is cause for great concern and could severely impede market functions. It causes confusion and uncertainty in the markets, is costly to business and will negatively impact the competitiveness of U.S. futures markets at home and abroad.

Example of FERC's Interest in Day-to-Day Regulation of Futures Exchanges

NYMEX has experienced the impact of overlapping jurisdiction on the regulatory front. At the insistence of FERC, NYMEX changed its procedures for monitoring positions in excess of the expiration position limits in its expiring natural gas (NG) futures contract. That procedural change *resulted in a 40% loss of volume* in NG futures contracts on NYMEX in the expiration month during the relevant closing range period. Data compiled by the House Energy Subcommittee on Oversight and Investigations confirms that the volume leaving NYMEX has moved to the non-transparent, price linked, unregulated electronic market for natural gas, ICE. This is a prime example of regulatory arbitrage: market activity on the highly regulated futures exchange shifting to the unregulated market to avoid rules designed specifically to deter and prevent market manipulation.

On February 16, 2007, in an effort to cooperate with FERC and following consultation with CFTC staff, NYMEX issued a compliance advisory in the form of a policy statement related to exemptions from position limits in NG futures contracts. NYMEX adopted this new policy on an interim basis in a good faith effort to be cooperative with federal regulators. However, as detailed below, this experience has had an adverse impact on NYMEX's trading venues and has resulted in the shifting of trading volume from the regulated trading venue to unregulated trading venues during the critically important NG closing range period at NYMEX on the final day of trading.

Pursuant to that advisory, NYMEX instituted new uniform verification procedures to document market participants' exposure justifying the use of an approved hedge exemption in the NG contract. These procedures apply to all market participants who carry positions above the standard expiration position limit of 1,000 contracts going into the final day of trading for the expiring contract. Specifically, prior to the market open of the last trading day of each expiration, NYMEX now requires all market participants with positions above the expiration position limit of 1,000 contracts to supply information on their complete trading "book" of all natural gas positions linked to the settlement price of the expiring NG contract. Positions in excess of 1,000 contracts must offset a demonstrated risk in the trading book, and the net exposure of the entire book must be no more than 1,000 contracts on the side of the market that could benefit by trading by that market participant during the closing range.

After eleven contract month expirations under the advisory, NYMEX analyzed data relative to the first 10 months of trading under the advisory. NYMEX staff observed a number of instances where market participants reduced their positions before the open of the final day of trading rather than share sensitive proprietary trading information with Exchange staff. As a result, NYMEX observed reduced trading volume on the final day of trading in an expiring contract month relative to the final day of trading for the same calendar contract month in the prior year. The average volume on the final day of trading for these ten expirations was 30,955 versus 38,623 for the corresponding contract month in the prior year, or a 19.85% reduction

Even more significantly, the closing range volume for the 30-minute closing period on the final day of trading is sharply lower than for volume during the final day closing range for the same calendar contract month in the prior year. In most instances, the volume in the closing range is less than half of the volume in the closing range for the same calendar contract month in the prior year. The average closing range volume on the final day of trading for the ten expirations was 13,136 versus 22,319 for the corresponding contract month in the prior year, or a 41% reduction.

The lower volumes seen during the recent 30-minute closing ranges on the final day of trading since the implementation of the new policy actually create the potential for even greater volatility in the event of any significant market move. Thus, the policy implemented by NYMEX on a good-faith basis has not only led to reduced volume on NYMEX during the critical 30-minute closing range period, which has largely shifted to the unregulated trading venues, but has also failed to solve the structural imbalances brought to light by Amaranth's trading. In addition, this policy could create new problems by diminishing the vitality of the natural gas industry's pricing benchmark.

The CFTC's role continues to be over futures trading and markets and the FERC's new authority is best used to police natural gas and electricity cash market manipulation. The CFTC and FERC can carry out their statutory duties in the futures and spot markets, respectively. CFTC and FERC should cooperate and coordinate in instances where both spot and futures markets are involved in a situation involving a bad actor, rather than having FERC exercising direct authority over transactions that are under the exclusive jurisdiction of the Commodity Exchange Act.

Conclusion

Under the CFMA, energy derivatives can be traded on a DCM, which is fully regulated by the CFTC, or OTC on an ECM or through a voice broker. A DCM has an affirmative statutory obligation to act as a self-regulatory organization, relying upon the standards set by statute and by CFTC regulation and interpretation. As an SRO, a DCM routinely uses tools such as large trader reporting and position accountability and position limit levels to monitor and to police trading in our contracts.

The ECM originally was essentially exempt from substantive CFTC regulation and also had no explicit SRO duties by statute. As a result of market changes that were not anticipated in 2000, such as the effective linking of trading on unregulated venues with trading on regulated venues of competing products, certain ECMs now serve in a price discovery role for certain contracts and thus, in the view of Congress, trigger public policy concerns and thereby warrant a higher degree of CFTC oversight and regulation. The CFTC Reauthorization Act of 2008 amended the CEA so that SPDCs traded on an ECM would be subject to nine core principles, including large trader reporting, position limits or position accountability, self-regulatory oversight obligations, and emergency authority. These statutory changes are consistent with CFTC recommendations, had the support of the President's Working Group on Financial Markets, and represent a judicious and targeted legislative response to a set of issues that were defined with care over a period of time.

Finally, the jurisdictional dispute between the CFTC and FERC stems from the EPA of 2005, which granted FERC new manipulation authority over electricity and natural gas transactions. Congress granted the CFTC exclusive jurisdiction over futures markets when it originally established the agency. The CFTC's role continues to be maintaining jurisdiction of futures trading and markets and the FERC's new authority is best used to police natural gas and electricity cash market manipulation.

NOTES

1. Exempt Commodity – "The term 'exempt commodity' means a commodity that is not an excluded commodity or an agriculture commodity." 7 U.S.C. §1a (14).
2. "Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets", CFTC (October 2007).
3. Letter to The Honorable Michael D. Crapo from the President's Working Group on Financial Markets (PWG) in response to Senator Crapo's letter to the PWG dated October 30, 2007.
4. 7 U.S.C. § 7(b) (1)-(8).
5. 7 U.S.C. § 7(d) (1)-(18).
6. ICE Clear Europe™, a wholly-owned subsidiary of IntercontinentalExchange has announced its intention to provide clearing services for ICE Futures Europe™ and for ICE OTC trading later this year.
7. "Excessive Speculation in the Natural Gas Market", Staff report by the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs, 110th Cong, 1st Sess. June 25, 2007.
8. "October 2007 CFTC report, at p. 11.
9. Id. The CFTC convened its first meeting of the Energy Markets Advisory Committee on June 10, 2008.
10. Id. at p. 3.
11. The amendments to the CEA. in addition to addressing SPDCs, address retail foreign currency transactions, clarify the CFTC's anti-fraud authority over principal-to-principal transactions, increase criminal and civil penalties for violations of the CEA, and establish deadlines for risk-based portfolio margining for security options and security futures products and for resolving issues related to foreign security indexes. (CFTC Reauthorization Act of 2008).
12. New York Mercantile Exchange, No. EL 95-81-000, 74 FERC ¶ 61311 (1996).