Before the
**FEDERAL TRADE COMMISSION**
Washington, D.C.

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| In the Matter of | ) | |
| | ) | |
| Market Manipulation Rulemaking | ) | No. PO82900 |
| | ) | |

**COMMENTS OF THE**
**INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.**

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**COMMENTS OF THE**
**INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.**

The International Swaps and Derivatives Association, Inc. ("ISDA") respectfully submits the following comments in response to the Federal Trade Commission's (the "Commission" or "FTC") Revised Notice of Proposed Rulemaking; Request for Public Comment, with respect to Prohibitions on Market Manipulation and False Information in Subtitle B of Title VIII of the Energy Independence and Security Act of 2007 ("RNPRM").[1]

I. Interest Of ISDA In The Revised Proposed Rulemaking

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has over 820 member institutions from 57 countries on six continents. These members include major institutions that deal in privately negotiated derivatives transactions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ISDA coordinates efforts to identify and reduce sources of risk for its members. In order to reduce regulatory risk, ISDA regularly participates in federal agency rulemaking proceedings that likely will affect the derivatives industry. In addition, as a means to manage legal and documentation risk, ISDA developed the ISDA Master Agreement, the form of master trading agreement that is the recognized standard in the derivatives industry. ISDA also has developed

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[1] 74 Fed. Reg. 18304 (April 22, 2009); Energy Independence and Security Act of 2007, Pub. L. No. 110-140, 121 Stat. 1492 ("EISA").

annexes to the ISDA Master Agreement that facilitate the wholesale trading of various products and commodities by parties under the ISDA Master Agreement framework, including for physical crude oil and other petroleum products traded on pipelines. Through these and related initiatives, ISDA promotes sound risk management and risk reduction practices and advances the understanding and treatment of derivatives from the public policy and regulatory capital perspectives.

Many ISDA members purchase and sell physical crude oil, gasoline and petroleum distillates and other wholesale energy commodities, and trade derivatives contracts based upon notional quantities of those commodities. ISDA and its members are committed to supporting open, fair and competitive wholesale energy markets and encouraging transparent and effective enforcement programs to preserve the integrity of these markets.

## II. Overview Of ISDA's Comments

ISDA appreciates the Commission's thoughtful consideration of the many comments, including those submitted by ISDA, that it received in response to the ANPRM and the NPRM.[2] ISDA believes that the RNPRM includes several significant improvements over the NPRM. In particular, ISDA believes that the Commission has made an important enhancement to the ability of firm's to ensure compliance with the rule by adding the requirement that to be unlawful an intentional omission must "distort or tend to distort" market conditions for the covered product. Nevertheless, ISDA respectfully submits that the alternative language proposed by the Commission on page 18327 of the RNPRM, which requires intentionally fraudulent conduct that distorts or tends to distort market conditions, is more appropriate for the wholesale petroleum,

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[2] ISDA repeats and incorporates by reference the comments ISDA submitted on June 23, 2008 in response to the Commission's Advance Notice of Proposed Rulemaking in this matter ("ANPRM") and on October 17, 2008 in response to the Commission's Notice of Proposed Rulemaking ("NPRM").

gasoline and distillates markets, and recommends that the Commission adopt a final rule based on the alternative language. By focusing solely on intentionally fraudulent activity, the alternate rule better defines the scope of permissible and impermissible conduct.

If the Commission chooses to adopt the revised proposed rule, ISDA encourages the Commission to modify the rule to apply the "distort or tend to distort" requirement and intentional conduct standard to both prongs of the rule. These revisions will make the rule more consistent with the anti-manipulation standard already applicable to the physical, wholesale petroleum markets. Given the Commission's statement that it will coordinate closely with the Commodity Futures Trading Commission ("CFTC") in the same and analogous markets, it should promulgate a manipulation rule that is reasonably consistent with the anti-manipulation standard applied by the CFTC.[3] This will ensure that both agencies implement their anti-manipulation enforcement programs in a coordinated and efficient manner.

## III. The Commission's Statutory Mandate

The EISA authorized the Commission to prosecute and punish manipulation in the wholesale crude oil, gasoline, and petroleum distillates markets and to promulgate a rule pursuant to Section 811.

Section 811 of the EISA makes it unlawful for any person:

> to use or employ, in connection with the purchase or sale of crude oil[,] gasoline[,] or petroleum distillates at wholesale, any manipulative or deceptive device or contrivance, in contravention of such rules and

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[3] *See* Section 2 of the Commodity Exchange Act, 7 U.S.C. § 2 (a)(1)(A) (2006) ("The Commission shall have exclusive jurisdiction . . . with respect to accounts, agreements . . ., and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated or derivatives transaction execution facility. . ."). Because Congress granted the CFTC exclusive jurisdiction over listed derivatives transactions (*i.e.*, futures and options on futures), the Commission should clarify that it will defer to the CFTC with respect to any manipulative activity that it becomes aware of that does not directly involve a wholesale, physical petroleum products transaction.

> regulations as the [FTC] may prescribe as necessary or appropriate in the public interest or for the protection of United States citizens.

Section 813 of the EISA provides for penalties of up to $1 million per day per offense.

## IV. The Commission's Rulemaking

### A. **The Revised Proposed Rule**

The revised proposed rule makes it unlawful for:

> any person directly or indirectly, in connection with the purchase or sale of crude oil, gasoline or petroleum distillates at wholesale, to:
>
> (a) Knowingly engage in any act, practice or course of business – including the making of any untrue statement of material fact – that operates or would operate as a fraud or deceit upon any person [(the "**fraud prong**")]; or
>
> (b) Intentionally fail to state a material fact that under the circumstances renders a statement made by such person misleading, provided that such omission distorts or tends to distort market conditions for any such product [(the "**omissions prong**")].

### B. **The Alternate Rule**

The alternate rule would make it unlawful for:

> any person directly or indirectly, in connection with the purchase or sale of crude oil, gasoline or petroleum distillates at wholesale, to engage in any act (including the making of any untrue statement), practice, or course of conduct with the intent to defraud or deceive, provided that such act, practice or course of conduct distorts or tends to distort market conditions for any such product.

## V. The Commission Should Adopt The Proposed Alternate Rule

We understand that the Commission is striving to adhere to what it interprets to be Congressional intent to vigorously prosecute dishonesty in wholesale, physical commodity markets. That goal is best met by adopting the alternate rule. The alternate rule is better suited to commodity markets than the revised rule because it:

- Focuses on intentionally fraudulent or deceptive behavior;

- More clearly requires intent to defraud or deceive as opposed to the revised rule, which applies the scienter requirement to any volitional act that operates or would operate as a fraud; and

- Requires as an element of the violation that the fraudulent conduct "distort or tend to distort" the market.

### A. Focusing on Intentionally Fraudulent Behavior is Most Appropriate For Wholesale Petroleum Markets

The alternate rule is better suited to the wholesale petroleum markets because it focuses on intentionally fraudulent acts and practices that distort or tend to distort market conditions. ISDA agrees with the Commission's acknowledgement that it should modify its SEC Rule 10b-5 approach to "better focus [the proposed rule] on wholesale petroleum markets, which differ significantly from securities markets."[4] Unlike securities markets, the markets for wholesale petroleum products are comprised exclusively of sophisticated, commercial parties transacting at arm's-length to procure or sell a commodity. Participants in these markets do not rely on analogous issuer-specific information when deciding whether to transact, and they have no duty to disclose proprietary information.[5] Rather, they are guided by their ability to source or sell their products to sellers or buyers in an open market where terms are negotiated.

As noted in ISDA's prior comments, a rule that is derived from regulations designed for securities markets, whose structure and duties are vastly different from those of the wholesale petroleum markets, could very well chill legitimate commercial behavior. By focusing on

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[4] *See* RNPRM at 18310.

[5] In fact, the CFTC published a report in 1984 acknowledging that trading in order to profit from one's own cash or futures market position is legitimate commercial behavior. The report concluded "[t]he ability of any person to capture the value of his or her proprietary information is a traditional prerogative of commercial enterprise. Because the futures markets are derivative, risk-shifting markets, it would defeat the market's basic economic function – the hedging of risk – to question whether trading based on knowledge of one's own position were permissible." CFTC, *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information* (Sept. 28, 1984).

intentionally fraudulent conduct that distorts or tends to distort market conditions, the alternate rule strikes a more appropriate balance for wholesale petroleum markets.

### B. The Commission Should Require Proof of Intentional Rather Than Reckless Conduct

Any rule that the Commission enacts should require proof that a market participant specifically intended to engage in a fraudulent or deceptive practice in connection with the wholesale purchase or sale of physical crude oil, gasoline, or petroleum distillates. The statutory language in Section 811 inherently requires proof of specific intent. Indeed, the word "manipulative" is a term of art that means "an intentional exaction of a price determined by forces other than supply and demand." In fact, although many courts interpreting this language in the securities context have required only a showing of recklessness or "severe recklessness" (the standard used in the majority of circuit courts), the Supreme Court has reserved the question of whether a showing of recklessness is enough to prove a violation of Rule 10b-5. Indeed, unless the market participant intended to distort prices, its activity should not be covered by an anti-manipulation rule.

That said, as between the revised proposed rule and the alternate rule, the Commission should adopt the alternate rule because it requires intentionally fraudulent conduct, rather than merely reckless conduct. The wholesale, physical commodity markets are comprised of sophisticated market participants that have to make trading and marketing decisions in real time, in many cases without perfect information. This makes it very important that the Commission only prosecute intentionally fraudulent conduct, rather than conduct that in retrospect, appears to be the type of conduct that the entity "must have known" would operate as a fraud. The intentional standard also aligns more closely with the Commission's other market-protection statutes (*e.g.*, the Sherman and Clayton Acts), which also require proof of specific intent,

including to prove fraud (*e.g.*, the "Walker Process" cases), and the CFTC's anti-manipulation standard.[6]

The Commission articulated the intent standard applicable to the alternate rule as follows:

> The phrase "with the intent" shall mean that the alleged violator intended to mislead – regardless of whether he or she specifically intended to affect market prices (e.g., specific intent), or knew or must have known of the probable consequences of such conduct – and regardless of whether the conduct was likely to succeed in defrauding or deceiving the target.

A number of market participants have expressed a concern that this definition is less than clear. ISDA, therefore, encourages the Commission to clarify the definition by (1) inserting parentheses before the first use of the word "regardless" and after the word "target", (2) deleting the hyphens, and (3) deleting "(e.g., specific intent)". ISDA proposes a revised definition as follows:

> The phrase "with the intent" shall mean that the alleged violator intended to mislead (regardless of whether he or she specifically intended to affect market prices or knew or must have known of the probable consequences of such conduct, and regardless of whether the conduct was likely to succeed in defrauding or deceiving the target).

These minor changes should avoid some confusion over the meaning of the definition without changing the Commission's apparent intention.

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[6] Many offenses under the Sherman Act require proof of specific intent. *See, e.g.*, *Spectrum Sports v. McQuillan*, 506 U.S. 447, 456 (1993) (specific intent to monopolize required); *H.J., Inc. v. Int'l Tel. & Tel. Corp*., 867 F.2d 1531, 1540 (8th Cir. 1989) (plaintiff needed to prove defendants specifically intended to control prices or destroy competition to establish an attempt to monopolize); *Bonjorno v. Kaiser Aluminum & Chem. Corp.*, 752 F.2d 802 (3rd Cir. 1985) ("[t]he plaintiff must present evidence that the defendants deliberately produced the effect, sufficient to provide a reasonable basis for the jury to conclude that the 'squeeze' was not the result of natural market forces such as supply and demand or legitimate competition."); *Papst Motoren GmbH v. Kanematsu-Goshu (U.S.A.) Inc*., 629 F. Supp. 864 , 870 (S.D.N.Y. 1986) ("Walker and its progeny emphasize that to sustain [defendant's] antitrust counterclaim, 'deliberate fraud' is required: 'there must be allegations and proof of knowing, willful and intentional acts of misrepresentation to the Patent Office.'") (quoting *Erie Tech. Prods. v. JFD Elec. Components Corp*., 1978 U.S. Dist. LEXIS 19704 (E.D.N.Y. 1978)). The Commission's consumer protection precedent (which does not require proof of scienter) is not relevant because it is based on different statutory language and (as discussed in ISDA's comments to the ANPRM) should not apply to wholesale commodity markets involving transactions between sophisticated principals.

1. *The Commission should apply the scienter standard to the fraudulent act rather than any volitional act that may operate as a fraud*

The alternate rule also is better suited to wholesale petroleum markets because it requires that the perpetrator intend to commit a fraudulent act, as opposed to merely requiring intent to engage in any volitional act that happens to "operate as a fraud". For example, although an entity may intend to engage in a particular act (*i.e.*, making a statement), the rule should not be satisfied unless the entity actually intended to make a false statement. In contrast, the revised proposed rule prohibits "knowingly engage[ing] in any act, practice or course of conduct," but does not expressly require knowledge or intent that the act be fraudulent or that the act "operate as a fraud." Although some authority would require the *mens rea* to be applied to each element of the rule, as drafted, the revised rule could result in time-consuming first amendment challenges as occurred with respect to the false reporting prohibition in the CEA.[7] The first amendment requires that a statute (or in this case, a rule) be narrowly tailored to prohibit only the speech necessary to protect the compelling governmental interest.[8]

The Commission should, therefore, expressly require as an element of the violation that the perpetrator intend to commit a fraudulent act in order to violate the rule. The alternate rule

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[7] *See, e.g., United States v. Valencia*, 2003 U.S. Dist. LEXIS 15264, at *68 (S.D. Tex. 2003) (finding the false reporting prong of CEA 9(a)(2) overbroad on its face because it failed to require that the defendant know that the information provided was false or misleading, but severing the unconstitutional portion and allowing the claim to proceed based on the submission of knowingly inaccurate reports.), *reversed and remanded by*, 394 F.3d 352 (5th Cir. 2004) (construing the statute to apply the scienter requirement to each element in order to save it from being unconstitutionally overbroad).

[8] *See, e.g., United States v. X-Citement Video, Inc.,* 513 U.S. 64 (1994); *United States v. Valencia*, 2003 U.S. Dist. LEXIS 15264, at *55 (S.D. Tex. 2003) ("An overbroad statute is one that punishes speech that is not constitutionally protected, but includes within its scope protected speech"). The Commission's rule is likely to be considered to address non-commercial speech for purposes of the first amendment analysis. The *Valencia* court held that a statute prohibiting the making of false reports swept in language that was not necessarily commercial language, which is defined as language that proposes a commercial transaction. As such, the statute was subject to strict scrutiny on first amendment grounds. *Id.* at * 66.

most clearly meets this standard by requiring that the prohibited conduct be engaged in "with the intent to defraud or deceive."

### C. Only Activity That Distorts Or Tends To Distort Market Conditions Should Be Addressed By The Rule

The Commission should require proof of market effect to find a violation of the rule because public policy only should be concerned with fraudulent activity that actually affects market prices and, therefore, presumably harms wholesale petroleum products markets. Moreover, Section 811 of EISA authorizes the Commission to propose a rule prohibiting manipulative activity, which is activity that distorts the market. That said, the alternate rule is better suited to wholesale petroleum markets than the originally proposed rule because it at least focuses on fraudulent activity that is directed toward and could distort market prices.

Whether a particular communication distorts or tends to distort market conditions will depend on the particular facts, however, ISDA encourages the Commission to clarify that the rule is not intended to address private communications that occur between individual market participants, but rather is focused on fraudulent activity that is directed toward the market. Depending upon the circumstances, a news release or a report used by an index publisher may be indicative of a communication that would meet the requirements of the rule.[9] As discussed above and as argued by a number of commenters and participants at the Commission's Market Manipulation Rulemaking Workshop held on November 6, 2008 (see Workshop Tr. at pp. 23-32), the aim of Section 811 is to prevent manipulation, which is a particular form of fraud, not one occurring between two counterparties, but rather, a fraud directed toward the market. The

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[9] *See, e.g., United Egg Producers v. Bauer International Corp*., 311 F. Supp. 1375 (S.D.N.Y. 1970); *In re Michelle Valencia*, 2003 U.S. Dist. LEXIS 15264 (S.D. Tex. 2003).

Commission has alternate methods of pursuing fraudulent activity between individual market participants, including Section 5 of the FTC Act.

In its RNPRM, the Commission stated that communications between market participants "may serve as a conduit for the dissemination [of] information." (RNPRM at page 18318). This position vitiates the limitation inherent in the "distort or tends to distort" element of the rule and would take the rule outside the scope of its statutory mandate. Moreover, sophisticated market participants transacting in wholesale petroleum markets generally should not be presumed to act in reliance upon their counterparty's statements, thus, information shared in that context should not be considered to be disseminated to the market. In fact, it is not uncommon for such market participants to represent and warrant to each other that each party is NOT relying on any statements made by the other in the context of negotiating transactions.

Including private conversations within the ambit of the rule also threatens to chill important communications occurring between market participants. For example, market participants often provide each other with "market color" with respect to market trends and the like, which is an important and appropriate source of information that facilitates the ability of a party to determine the price it believes to be appropriate to enter into a purchase or sale transaction.

## VI. In The Alternative, The Commission Should Adopt The Revised Rule With Certain Modifications

If the Commission adopts the revised rule, it should modify the rule to apply (1) the "intentional" standard of scienter, and (2) the "distort or tend to distort" element to both prongs of the rule for the reasons discussed above. If the Commission does not apply the "intentional" standard to the first prong of the revised rule, the Commission should still retain the heightened

standard for the omissions prong because of the increased risk of capturing inadvertent omissions within the ambit of the rule.

The Commission should revise the definition of knowingly to delete the clause "with actual or constructive knowledge" (page 18327) to provide greater clarity to market participants. The Commission has proposed the following definition: "*Knowingly* means *with actual or constructive knowledge* such that the person *knew or must have known* that his or her conduct was fraudulent or deceptive." (Emphasis added). The commonly understood meaning of "knew or must have known" is to have actual or constructive knowledge. Including duplicative language in the definition could have unintended effects. Pursuant to common canons of statutory interpretation, a court interpreting a statute or rule is charged not to render superfluous parts of the statute. Thus, a court may infer that the Commission intended something other than a mere restatement of the standard by including both "with actual or constructive knowledge" and "knew or must have known" in the definition.

## VII. ISDA"s Response to Questions Posed By The Commission

### A. **Response to Question 1(a) (page 18325)**

*In considering whether the revised proposed rule strikes the appropriate cost/benefit balance, discuss the merits and/or flaws of having one intent standard, consolidating the rule into a single anti-fraud prohibition, and including the distort or tend to distort proviso.*

ISDA encourages the Commission to enact the alternate rule or to consolidate the revised proposed rule into a single anti-fraud prohibition with the scienter requirement increased from knowingly to intentionally and the retention of the "distorts or tends to distort" element. For the reasons discussed above, this would strike a more appropriate balance between protecting the wholesale petroleum markets from manipulation and limiting the compliance and other costs on industry. Market manipulation and reduced market activity negatively affect both consumers

and market participants. The Commission should, therefore, strive to promulgate a narrowly-tailored rule that addresses intentionally fraudulent acts or practices and provides clear guideposts for market participants to monitor and deter prohibited manipulation within their organizations without chilling legitimate business conduct.

B. **Response to Question 2(b)(2) (page 18326)**

*Does Section 811 authorize the Commission to publish a rule that prohibits all conduct that operates or would operate as a fraud on any person, including common law fraud in which the injury may not extend beyond the individual parties or otherwise impair the integrity of wholesale petroleum markets?*

No. As discussed above, Section 811 does not authorize the Commission to prohibit conduct that does not extend beyond the individual parties or impair the integrity of wholesale petroleum markets. Section 811 of EISA authorizes the Commission to propose a rule prohibiting manipulative activity, which is activity that distorts markets. Moreover, the Commission only should be concerned with fraudulent activity that affects and, therefore, presumably harms wholesale petroleum markets. The Commission has other means, including Section 5 of the FTC Act, to pursue deceptive conduct between market participants. If the rule addresses private communications between counterparties that may have no effect (or even the tendency to effect) market conditions, market participants likely will say nothing rather than risk that appropriate statements later may be questioned as having been misleading.

C. **Response to Question 2(j) (page 18326)**

*Should the proposed rule be expanded to require that a person update or correct information if circumstances change?*

No. As discussed above and in prior ISDA filings in the ANPRM and NPRM, there is no duty imposed upon commodity market participants to disclose information. As such, there should be no duty to update or correct information. Such a requirement would create a level of

regulatory risk that would deter market participants from communicating in any substantive way with market participants.

D. **Response to Question 2(o) (page 18326)**

*Although the prohibition language in Section 811 is nearly identical to Section 10(b) of the SEA, does the statutory language in Section 811 provide a sufficient basis for tailoring the scienter requirement?*

Yes. Unlike the Federal Energy Regulatory Commission ("FERC"), which was required to consider securities precedent pursuant to Congress' express statutory instruction in the EPAct, the Commission has not been directed by Congress to apply this non-analogous precedent to the wholesale, physical petroleum products markets.[10] The different language in the EPAct and the EISA constitutes a mandate from Congress to take a different approach than that taken by the FERC. Indeed, "Congress is presumed to act intentionally and purposely when it includes language in one [statutory provision] but omits it in another."[11]

E. **Response to Question 2(r) (page 18326)**

*Does the "distort or tend to distort" provision unduly limit the Commission's ability to prohibit misleading statements that threaten the integrity if wholesale petroleum markets?*

No. In fact, the Commission should require proof of market effect to establish a violation because (1) manipulative activity is that which harms markets; and (2) an effects requirement would have less of a chilling effect on beneficial market activity. That said, the distort or tends to distort requirement also will benefit markets in that it better defines the scope of impermissible conduct than did the initially proposed rule because it should remove from the

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[10] *See* Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005) ("EPAct"), Sections 315 and 1283 (directing the FERC to interpret "any manipulative or deceptive device or contrivance (as those terms are used in Section 10(b) of the Securities Exchange Act of 1934").

[11] *See Estate of Bell v. Commissioner*, 928 F.2d 901, 904 (9th Cir. 1991).

ambit of the rule, private and other conversations and conduct that do not distort or tend to distort markets and with which the Commission should not be concerned.

This standard should not be a significant hurdle for the Commission. In any case in which an entity is actually engaged in intentionally manipulative conduct, it should not be difficult for the Commission to establish that the conduct engaged in distorts or tends to distort the market. For example, depending upon the individual circumstances, if a person intentionally submitted false transaction data to an industry publication that used the data to compile its index, this would be an indication of conduct that might distort or tend to distort market conditions.

## VIII. Summary Conclusion

ISDA appreciates the opportunity to provide comments on this important initiative. ISDA supports and encourages the development of dynamic markets undistorted by manipulative activity. Without limiting ISDA's recommendations in response to the ANPRM and the NPRM, given the choices posed in this RNPRM, ISDA recommends that the Commission enact the alternate rule. In the alternative, the Commission should enact the revised proposed rule, but should modify the rule to apply the "intentional" standard and the "distorts or tends to distort" element to both prongs of the rule. These modifications will enable the Commission more effectively to identify and prosecute manipulative conduct while maintaining open and competitive markets that complement an active enforcement program.

Respectfully submitted,

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