Before the
FEDERAL TRADE COMMISSION
Washington, D.C.

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") 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 ("NPRM").[1]

I. Interest Of ISDA In The Proposed Rulemaking

ISDA is the global trade association representing participants in the privately negotiated derivatives industry. ISDA has over 670 member entities from 47 countries. ISDA's members include most of the world's major institutions who deal in, as well as leading end-users of, privately negotiated derivatives transactions.

ISDA leads efforts to identify and reduce sources of risk for its members. In an effort 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 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

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[1] 73 Fed. Reg. 48317 (Aug. 19, 2008); Energy Independence and Security Act of 2007, Pub. L. No. 110-140, 121 Stat. 1492 ("EISA"). 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 ("ANPR").

understanding and treatment of derivatives from the public policy and regulatory capital perspectives.

Many ISDA members purchase and sell various wholesale, physical, crude oil, gasoline and petroleum distillates and other energy commodities, and trade derivatives contracts based upon notional quantities of such 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 time and consideration that the Commission has devoted to this NPRM, including to its ANPR. ISDA believes that the NPRM includes several significant improvements over the ANPR. In particular, ISDA commends the Commission for focusing the proposed Rule on prohibiting fraudulent and deceptive practices. (NPRM at 48320). ISDA also commends the Commission for clarifying that the proposed Rule does not impose affirmative disclosure requirements on sophisticated commercial market participants who are fully capable of protecting their interests in bilateral negotiations. (NPRM at 48322).

As an organization whose members participate in the dynamic crude and petroleum distillates markets, we believe that it is essential that any Rule promulgated by the Commission provide market participants with clear guidance about the scope of permissible and impermissible conduct. Decisions about risk management and trading strategies and transactions are made based on changing market conditions and a Rule that is overbroad, imprecise or both likely will chill legitimate commercial behavior, including the risk-shifting and management services that ISDA members provide to wholesale market participants. For this reason, ISDA encourages the Commission to require poof that an entity (1) specifically intended to engage in a

fraudulent or deceptive scheme designed to affect the price of a jurisdictional transaction; and (2) materially affected the price of a jurisdictional transaction so that it does not reflect supply and demand fundamentals.

We understand from our conversations with the Commission's staff that the Commission believes that a recklessness standard will sufficiently narrow its enforcement focus only to address intentionally fraudulent or deceptive schemes. We also understand from our conversations with staff that the Commission only would prosecute an entity for violations that meet the "materiality" standard as set forth in its Section 5 jurisprudence.[2] Given the Commission's stated goals, the Commission would not unduly limit its ability to prosecute fraudulent and deceptive conduct by explicitly requiring proof of specific intent and market effect to establish a violation of the Rule. At the same time, including these explicit requirements would increase regulatory certainty for market participants who will have the ability to develop compliance policies and programs to ensure adherence to applicable standards.

The uncertainty created by adopting a standard of recklessness and targeting conduct that does not necessarily actually affect the wholesale petroleum markets is significantly increased by: (1) the Commission's reliance on securities law precedent that does not readily relate to a wholesale commodities market; and (2) the potential application of the Rule to over-the-counter and listed (or futures) derivatives markets. Because the prohibitions of SEC Rule 10b-5 are derived from statutory duties that do not exist in the wholesale commodities markets, many market participants cannot determine what behavior (other than false or misleading statements) may be prohibited under Section 811.[3] The aggregation of these ambiguities creates

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[2] Federal Trade Commission Act, § 5, 15 U.S.C. § 45 (2006).

[3] 17 C.F.R. § 240.10b-5 (2008) ("SEC Rule 10b-5")

considerable uncertainty in the market. ISDA, therefore, encourages the Commission to enact a rule that is consistent with anti-manipulation law enforced by the Commodity Futures Trading Commission ("CFTC") in the same and analogous markets. ISDA also encourages the Commission to establish a formal mechanism to coordinate with other agencies, including the CFTC, with respect to any overlapping enforcement activities.

III. **<u>The Commission's Statutory Mandate</u>**

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 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. **<u>The Commission Should Not Rely On Securities Precedent</u>**

We understand from our conversations with staff that the Commission is striving to adhere to what it interprets to be Congressional intent to vigorously prosecute dishonesty in wholesale, physical commodity markets. We fully agree with that objective. However, it is not necessary, and in fact undesirable, to apply securities precedent to accomplish that goal.

In promulgating a Rule, the Commission should first look to the statute itself and ensure that it does not exceed the parameters set by the statutory language.[4] 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.[5] 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."[6] A letter from five Senators to the Commission urging it to look to securities precedent does not change the plain meaning of the statute as written. (NPRM at 48322).

Considering the differences between Section 811 and the EPAct, it is apparent that Congress used this language as short-hand to indicate the type of behavior it intended to prohibit (*i.e.,* manipulative and deceptive conduct) in order to distinguish between other types of conduct already prohibited under the Commission's antitrust and consumer-protection statutes, rather than to indicate that the Commission should follow the securities precedent developed pursuant to SEC Rule 10b-5. Securities precedent does not provide a helpful framework for developing the elements of a Rule prohibiting manipulation in wholesale, physical petroleum products

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4 *See FDA v. Brown & Williamson Tobacco Corp*., 529 U.S. 120, 161 (2000) ("the power to regulate in the public interest must always be grounded in a valid grant of authority from Congress. [An agency] must take care not to extend the scope of the statute beyond the point where Congress indicated it would stop.") (Internal quotations omitted).

5 *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").

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

markets because there are substantial differences between the markets. The securities laws are designed to promote the raising of capital by enterprises and to protect retail investors who may purchase or sell securities. Interwoven and inextricably part of securities regulation are a series of expansive disclosure requirements, which the Commission has acknowledged do not apply in this context (NPRM at 48322), including detailed standards regarding the information that an enterprise must disclose to current holders and potential purchasers and sellers of its securities. Rule 10b-5 was drafted in light of these disclosure requirements, which flow from relationships, such as between broker and client, advisor and client or a corporate insider and its corporation or other market participants – relationships that, unlike in the physical, wholesale petroleum products markets, are fundamental to the functioning of the securities markets. It is the nature of these relationships that gives rise to duties to disclose. In the absence of these types of relationships and the duties that flow from them, it is not clear how or if Rule 10b-5 principles can apply because the duties that trigger Rule 10b-5 liability do not exist in the wholesale, physical petroleum products markets.

The Commission cannot simply overlay securities law – a complicated and inherently different regulatory scheme – and expect it to "reduce regulatory uncertainty" with respect to its regulation of wholesale, physical petroleum products markets. (NPRM at 48322). Unlike securities markets, the markets for wholesale, physical 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.[7] 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.

Given the fundamental differences between the securities and commodities markets, promulgating a Rule that relies on securities precedent would not create the clarity the Commission seeks, but rather, would create greater confusion and uncertainty in the energy markets. For example, Section 317.3(c) of the proposed Rule prohibits reckless activity that "operates or would operate as a fraud or deceit" upon any person. The Commission has stated that this clause "is intended to be a catch-all provision that prohibits any other conduct that constitutes a fraud **on wholesale petroleum markets**." (NPRM at 48327) (emphasis added). While this clause may be reasonably clear in the securities context in which it has been applied, it is not clear to ISDA's members what this would require of commercial participants in physical, wholesale petroleum markets. What type of reckless behavior might be considered to "operate as a fraud upon the market"?

With the exception of an understandable duty not to affirmatively make a false or misleading statement, the duties that give rise to claims of deception and fraud in the securities context do not exist with respect to the principal-to-principal commercial transactions that comprise the physical, wholesale petroleum markets. If the Commission only intends for its Rule to reach false or misleading statements, it should draft the Rule accordingly. However, as

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[7] 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).

written, it appears to target additional, unspecified activity. ISDA's members are unable to determine to what additional activity the Rule applies.

We understand from our conversations with the staff that the Commission would like us to provide examples of legitimate commercial behavior that may be chilled as a result of this lack of clarity. As we explained to the staff, ISDA members engage in a variety of risk-shifting and arbitrage activities that require them to act concurrently in a variety of markets and in a fast-paced and volatile price environment. These may include entering into transactions with counterparties that are seeking to hedge their exposure to certain commodity price risks while at the same time conducting market making activities. Under the proposed Rule, market participants are likely to be concerned that their competitive trading strategies or inadvertent miscalculations may later be misconstrued by regulators questioning whether their activities recklessly may have operated as a fraud upon the market. Consequently, market participants undoubtedly will reduce these types of critical market activities because of the substantial costs associated with agency investigations – even those that do not result in prosecution. Other potential entrants may decide that the regulatory risks exceed the potential benefits and opt not to enter the market. Both of these consequences would adversely impact the liquidity of the markets generally. Moreover, this type of withdrawal from participation in the marketplace is more likely to occur in times of greater market stress (such as situations involving high or low prices or high volatility), thereby depriving the market from liquidity at a time when liquidity would be needed to relieve stressful conditions.

V. <u>The Commission Should Require Proof Of Specific Intent And Market Effect Consistent With The Approach Taken By The CFTC In The Same And Analogous Markets</u>.

A. Any Rule that the Commission enacts should require proof of specific intent to manipulate prices.

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 purchase or sale of physical crude oil, gasoline, or petroleum distillates at wholesale. 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."[8] 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.[9] In fact, the

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[8] *Frey v. CFTC,* 931 F.2d 1171, 1175 (7th Cir. 1991); *In re Soybean Futures Litig.,* 892 F. Supp. 1025, 1044 (N.D. Ill. 1995) (manipulation means "intentional conduct that has resulted in a price which does not reflect basic forces of supply and demand") (internal quotations omitted); *United States v. Reliant Energy Servs., Inc.,* 420 F. Supp. 2d 1043, 1055 (N.D. Cal. 2006) (to manipulate means "to control, manage or play upon by artful, unfair or insidious means").

[9] The First, Fifth, Sixth, Tenth and Eleventh Circuits require a showing of "severely reckless" conduct or conduct undertaken with a "conscious disregard." *See, e.g., In re Comshare, Inc. Sec. Litig.,* 183 F.3d 543 (6th Cir. 1999); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400 (5th Cir. 2001); *City of Philadelphia v. Fleming Co., Inc*, 264 F.3d 1245 (10th Cir. 2001). The Seventh and DC Circuits require an "extreme departure from the standards of ordinary care". *See Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (internal quotes omitted) (defining reckless conduct as any "highly unreasonable [act or omission], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."); *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992) (quoting *Sunstrand Corp*., 553 F.2d at 1045). We understand from our conversations with staff that the Commission intends to apply the more stringent standard articulated by the Seventh and D.C. Circuits. Applying a duty-based intent standard to a Rule that professes not to impose an affirmative duty of disclosure will decrease legal certainty about the conduct to which the Rule applies. If, despite that uncertainty the Commission elects to include a recklessness intent standard in the final Rule, ISDA encourages the Commission expressly to limit the application of the Rule to the "known or must have known" recklessness standard to ensure that the Rule is enforced consistently by the circuit courts.

Court in *Ernst & Ernst v. Hochfelder*, held that the word "manipulative . . . connotes **intentional** or willful conduct designed to deceive or defraud . . . by controlling or artificially affecting [prices]."[10]

In contrast to securities cases, a long line of circuit courts interpreting the Commodity Exchange Act's ("CEA") general statutory prohibition of manipulative behavior in commodity markets have required proof of specific intent to manipulate the price of a commodity.[11] This precedent is much more analogous to the markets the EISA seeks to protect. Both the EISA and the CEA prohibit manipulative conduct in wholesale, physical commodity markets comprised of sophisticated commercial parties making trading and marketing decisions in real time, in many cases without perfect information. In contrast to the SEA, they are both market-protection, as opposed to consumer-protection, statutes (*i.e.*, they both seek to protect the integrity of competitive markets without discouraging competition).[12] The Commission's market-protection statutes (*e.g.*, the Sherman and Clayton Acts) similarly require proof of specific intent, including with respect to proof of fraud (*e.g.*, the "Walker Process" cases).[13]

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

[11] It is settled law under the CEA that a finding of manipulation requires more than proof of intent to influence prices. It requires specific intent to create an artificial price. *See, e.g., Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971) ("The methods and techniques of manipulation are limited only by the ingenuity of man. The aim must be therefore to discover whether conduct has been intentionally engaged in which has resulted in a price which does not reflect basic forces of supply and demand."); *Accord G.H. Miller & Co. v. United States,* 260 F.2d 286 (7th Cir. 1958).

[12] Although the FERC adopted a recklessness standard for proof of manipulative intent, the Commission should rely instead on the CFTC's standard, which is a more appropriate standard for prosecuting manipulation in wholesale, physical petroleum products markets. FERC's historical role as a rate-setting agency, its broad authority to ensure "just and reasonable rates" in regulated energy markets, and its direction by Congress to consider SEC precedent distinguishes its jurisdiction from that of both the CFTC and the Commission.

[13] 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

(continued…)

Given the plain import of the statutory language as well as relevant commodities and FTC precedent, the Commission should require proof of specific intent to establish a violation of any Rule.[14] The Commission would be better served to adopt the standard of intent applicable to commodities markets, a standard that has been settled for the last seventy years.

B. **Any Rule that the Commission proposes should require proof that the manipulative conduct affected the price of a jurisdictional transaction**.

As discussed at greater length in ISDA's comments to the ANPR, the Commission should focus its resources on intentional manipulative conduct involving a jurisdictional transaction that also affects, and therefore presumably harms wholesale, physical petroleum products markets. This is consistent with the approach taken by the CFTC, as well as under the Commission's market-protection statutes, all of which require proof of "substantial lessening of competition."[15] ISDA is not suggesting that the Commission should require proof of anticompetitive effects as set forth in the antitrust laws. ISDA also acknowledges that it may be difficult to craft the ideal test for proof of effect. However, ISDA encourages the Commission to require proof that a party's manipulative conduct had some direct and material effect on price, particularly in light of the statutory mandate to prohibit market "manipulation" and the lack of

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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 ANPR) should not apply to wholesale commodity markets involving transactions between sophisticated principals.

[14] It is telling that even in the consumer-protection oriented securities context, the Supreme Court has reserved the question of whether recklessness is sufficient and courts disagree over how reckless a party's conduct must be to establish a violation. *See supra,* note 8.

[15] Fraud actions under the Sherman Act require proof of anti-competitive effect. *See, e.g., Walker Process Equip., Inc. v. Food Machinery & Chem. Corp.,* 382 U.S. 172, 177 (1965); *Rambus Inc. v. FTC*, 522 F.3d 456 (D.C. Cir. 2008).

precision about what is required by the proposed Rule. Furthermore, as a sound policy matter, conduct that actually harms markets is the only conduct with which the Commission should be concerned and to which it should devote its limited public resources.

Based on our conversations with staff, we understand that the Commission intends to apply a "materiality" requirement to the rule. However, the Commission in its proposed rulemaking only applies the standard to Section 317.3(b), limiting what statements or omissions may be considered for purposes of the Rule. This leaves considerable uncertainty with respect to what standard applies to Sections 317.3(a) and (c). (NPRM at 48326).

Requiring proof that the manipulative conduct affected a jurisdictional transaction also will reduce overlap with other agencies and promote the most efficient allocation of resources. In the NPRM, the Commission indicated its intent broadly to construe the language to reach conduct that not only involves, but affects, a jurisdictional transaction. (NPRM at 48325). ISDA recommends that the Commission reconsider this approach and narrow the scope of its Rule to require proof that an entity engaged in a jurisdictional transaction as part of its manipulative scheme. However, if the Commission promulgates a Rule reaching a broader scope of conduct, the Commission should require, as an element of a violation, proof that the conduct has in fact materially affected a jurisdictional transaction. Without this limitation, the Rule likely would exceed the Commission's statutory mandate. The Commission acknowledges this to some extent in its discussion of how its Rule might be used to prosecute conduct related to ethanol transactions – "ethanol may be covered under the proposed Rule where changes in ethanol prices directly or indirectly ***affect*** wholesale gasoline prices." (NPRM at 48325) (Emphasis added).[16]

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[16] The Commission should clarify that "retail sales" means not only gasoline sales to consumers, but sales of any jurisdictional petroleum product to consumers. (NPRM at 48325).

VI. **<u>The Commission Should Formalize A Procedure To Coordinate Enforcement With Other Agencies Where Appropriate</u>**

ISDA encourages the Commission to formalize a procedure for coordinating its efforts with other agencies so that the most appropriate regulator may take the lead with respect to areas in which their enforcement interests may overlap.[17] For example, 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 refer to the CFTC any manipulative activity that it becomes aware of that does not directly involve a wholesale, physical petroleum products transaction.[18] This will ensure that both agencies implement their anti-manipulation enforcement programs in a coordinated and efficient manner.

Concurrent prosecution does not benefit the regulators or the markets. Rather, it increases costs for regulators who have to brief the multitude of jurisdictional issues raised by defendants and potentially discourages the very competitive behavior that complements an active enforcement regime – with no added public benefit.

VII. **<u>Summary Conclusion</u>**

ISDA appreciates the opportunity to provide comments on this important initiative and both supports and encourages the development of dynamic markets undistorted by manipulative activity. ISDA, therefore, recommends that the Commission propose a narrowly-tailored anti-manipulation rule focused on punishing intentionally deceptive or fraudulent conduct involving a

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[17] *See, e.g.,* Memorandum of Understanding Between the Federal Energy Regulatory Commission and the Commodity Futures Trading Commission Regarding Information Sharing and Treatment of Proprietary Trading and Other Information (Oct. 12, 2005).

[18] *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. . .").

wholesale, physical petroleum transaction that affects price in a manner not reflecting supply and demand fundamentals. This standard will enable the Commission most 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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