Before the

FEDERAL TRADE COMMISSION

Market Manipulation Rulemaking, PO82900

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I. Introduction

The Federal Trade Commission ("Commission") is seeking comment on its Notice of Proposed Rulemaking on Prohibitions On Market Manipulation and False Information ("Rulemaking") in Subtitle B of Energy Independence and Security Act of 2007 ("EISA") [1]. Based on my experience, knowledge, and prior work in a regulatory capacity, I submit these comments on issues raised in the Rulemaking as the Commission deliberates on how to best implement its new authority under Subtitle B of the EISA.

I am presently an economist in the Securities and Finance Practice of National Economic Research Associates, Inc. ("NERA"), an economic consulting firm devoted to providing expertise and advisory services to business, government, and industry. I previously served as Commissioner on the U.S. Commodity Futures Trading Commission ("CFTC"), nominated by President George W. Bush and confirmed by the U.S. Senate for my first term in 2002, and a second term in 2004. I also served as Acting Chairman of the CFTC from July 2004 until July 2005. I served as a member of the President's Working Group on Financial Markets with the Secretary of the Treasury, Chairman of the Federal Reserve Board, and the Chairman of the Securities and Exchange Commission ("SEC"). At the end of July 2006, I left the CFTC to join NERA.

[1] Pub. L. 110-140, 121 Stat. 1723, title. VIII, subtitle. B, to be codified at 42 U.S.C. §§ 17301-05.

While at the CFTC, I was designated to take the lead in evaluating legislation, issues and economic developments of relevance to the nation's energy markets. I have addressed numerous governmental, financial organizations and associations, and forums on energy market issues, including the International Monetary Fund, the Energy Bar Association, the Edison Electric Institute, and the World Forum on Energy Regulation. I testified on the function and regulation of the U.S. futures and options markets and the Reauthorization of the CFTC before the Senate Committee on Agriculture, Nutrition and Forestry, and the House Subcommittee on General Farm Commodities and Risk Management. I have written extensively on the law and economics of market manipulation, with focus in recent years on the energy markets, and have published in the *Futures and Derivatives Law Report* and the *Capital Markets Law Journal*.

Prior to my public service, I was an Assistant Professor of Finance at George Mason University (1998-2002) and at Tulane University (1995-1998). My articles appear in *Barron's*, the *Journal of Futures Markets*, *Regulation*, and the *Review of Futures Markets*. I hold a Ph.D. and MA in economics and a BA in economics and international studies from Virginia Polytechnic Institute and State University in Blacksburg, Virginia.

Based on my experience as a former regulator of commodity futures markets (including oil, gasoline, and natural gas markets), expertise, and writings on market manipulation, I provide these general comments on issues that I hope will assist the Commission as it endeavors to implement its new authority under Subtitle B of the EISA. These comments are my own and do not necessarily represent those of NERA, clients of NERA, or my former agency, the CFTC.

II. Background

Subtitle B of the EISA prohibits manipulative or deceptive conduct and the supply of false information to the federal government. Specifically, Section 811, entitled "Prohibition on Market Manipulation," declares it unlawful for anyone, in connection with the wholesale purchase or sale of crude oil, gasoline, or petroleum distillate in the wholesale market, to use "any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Federal Trade Commission may prescribe as necessary or appropriate in the public interest or for the protection of United States citizens."

The wholesale petroleum markets covered by Section 811 differ in important respects from the derivative markets regulated by the CFTC, the securities markets governed by the SEC, and the regulated energy markets overseen by the Federal Energy Regulatory Commission ("FERC"). The language contained in section 811 derives substantially from the securities law proscribing fraud, Rule 10b-5,[2] which was promulgated to protect investors who take an ownership stake in publicly traded equities. FERC's statute, as articulated in the Energy Policy Act of 2005, adopts the same antifraud language taken from securities law and aims to rely on the same legal precedent.

The distinctions between derivatives and securities, and the diverse mechanisms by which market participants negotiate and enter into transactions in organized, regulated markets versus bilateral wholesale petroleum markets, are highly relevant to the approach that the Commission ultimately adopts. The importance of petroleum products to the continued growth of the economy demands that the Commission pursue a well-reasoned and careful approach that takes these factors into account for the long-run health of the market and benefit of consumers.

III. Challenges of Applying Securities Market Standards to Wholesale Petroleum Markets

In the Rulemaking, the Commission adopts the standards and the language of SEC Rule 10b-5. It further adopts the general conduct proscriptions of securities law, and in so doing, it affords significant discretion to the Commission. As noted in the Rulemaking, "The Commission believes that adopting the general conduct prohibitions embodied in SEC Rule 10b-5 provides the necessary flexibility for the Commission to adapt to changing market conditions in enforcing its proposed Rule." [3]

In its efforts to identify the precedents relevant to proscribing market manipulation in wholesale petroleum markets, the Commission acknowledged that there are divergent statutory and

[2] Securities and Exchange Act of 1934, Section 10(b), 15 U.S.C. 78j(b); Rule 10b-5, 17 C.F.R. 240.10b-5.

[3] Federal Trade Commission, 16 CFR Part 317 "Prohibitions on Market Manipulation and False Information in Subtitle B of the Energy Independence and Security Act of 2007" ("Rulemaking,") p. 22.

regulatory standards, and sought guidance on the elements that should be considered.[4] The fundamental challenge of the Commission's task is to implement the SEC 10(b) standard, designed to prevent deception and fraud perpetrated on retail investors, and relate it to wholesale petroleum transactions between sophisticated commercial market participants.

While the market structure for listed securities differs substantially from that of the wholesale markets, the mission of the Commission is more analogous to that of the commodities market regulator, the CFTC, which has the responsibility to ensure that the prices derived from and used by futures markets are fair and free from fraud and manipulation.[5] The commodities law and regulatory focus derive from a public policy directive to encourage and protect the price discovery and risk management function of the organized markets.[6] While certain elements of for a cause of action in the futures markets are inapposite to section 811, the emphasis on and promotion of efficient price discovery and the deference to legitimate commercial market uses of contracts provide important guideposts.

Whereas futures contracts are homogeneous contracts exchanged in a central marketplace or through a central electronic network, transactions in the wholesale petroleum markets primarily consist of bilateral, privately negotiated deals. Counterparties acting competitively and in their own self-interest exchange quotations and arrive upon a price that best reflects their demands and their sentiment regarding the value of the commodity. The fact that prices must be *discovered* highlights the recognition that both parties to a transaction bring something to the table, and the negotiation that takes place is critical to efficient price formation.

While "manipulative or deceptive" conduct would be prohibited under virtually any reading of the statutory language, its interpretation must be focused so as not to include pro-competitive

[4] Federal Trade Commission, 16 CFR Part 317 "Prohibitions on Market Manipulation and False Information in Subtitle B of the Energy Independence and Security Act of 2007" ("Advance Notice,") p. 9.

[5] "To foster these public interests, it is further the purpose of this Act to deter and prevent price manipulation or any other disruptions to market integrity." *Commodity Exchange Act,* 7 U.S.C §5 "Protection of the Public Interest", Sec. 3, Para. 1032(b). .

[6] Futures contracts "are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities." *Commodity Exchange Act,* 7 U.S.C §5 "Protection of the Public Interest", Sec. 3, Para. 1031(a).

conduct that arises in a counterparty's efforts to get the best price. The competitive quotations exchanged between two counterparties with diverse and opposite interests, one with a desire to buy and the other to sell, summarizes their discrete demand and supply and any information they possess that led them to seek to transact in the first place.

Anything that would alter or discourage the competitive urge to obtain the best price in the negotiation process, or that would interfere with the right of the counterparties to pursue their own commercial and economic interests, runs the risk of harming market efficiency and price discovery. For example, if the price discovery process is impaired in some way, such as would occur if market participants are discouraged from transacting based on commercial information because it might lead to a transaction whose price deviates from that obtained by others or deemed to be "artificial" or "uneconomic," then price discovery may be hindered.

Like all commodity prices, petroleum prices exhibit volatility and dispersion. Volatility of prices is the result of normal manifestations of uncertainty regarding supply and demand (which are often not observable with precision), revisions in trader assessments regarding the value of the asset due to news and information, and macroeconomic factors.[7]

In the wholesale petroleum markets, various factors can affect transactions prices and can lead to price dispersion, or the potential for different prices to prevail for the same asset. The possibility that there may not be a single market price, or that price may change significantly or frequently over time (and thus exhibit volatility) is due to imperfect information, unforeseen or unpredictable events that will impact supply and demand, and frictions common to most commodity markets. These frictions – such as illiquidity or the possibility that buyer demand and seller supply are non-synchronous – and constraints on transportation and storage, make it difficult to regard wholesale contracts as fungible, as is the case with securities and futures contracts. Thus, wholesale market prices can vary across geographical regions and over time, and recognizing these legitimate and commercially relevant factors is important to enforcing rules that govern price formation.

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[7] See, for example, G. William Schwert, "Why Does Stock Market Volatility Change Over Time?" *The Journal of Finance* 44, no. 5, (Dec. 1989), Louis H. Ederington and Jae Ha Lee, "How Markets Process Information: News Releases and Volatility," *The Journal of Finance* 48, no. 4, (Sep. 1993), and Hans Stoll and Robert Whaley, "Stock Market Structure and Volatility," *Review of Financial Studies* 3, no. 1, (1990),.

IV. Market Transparency and Price Formation in Bilateral Markets Where Information is Often Proprietary and Commercially Sensitive

Section 317.3(b) of the proposed Rule makes it a violation to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, not misleading."[8] This is another instance where the Commission should exercise caution, particularly as it relates to what constitutes an omission of material information and the implications for wholesale market participants.

The securities law for publicly traded equities is premised on the supposition that managers of the firm have an obligation to shareholders not to trade on nonpublic information that is material, since it is a misappropriation by individuals with fiduciary responsibility over corporate property.[9] This follows agency theory in economics, which recognizes that firm managers are agents of the shareholders who hold an ownership claim on the firm as a result of their equity holdings. Since securities law is aimed at protecting investors, the disclosure requirements and insider trading laws exist to ensure that information relevant to firm value is not misappropriated from shareholders.

Commodities law does not prohibit entities from trading on material nonpublic information in the futures markets, but instead relies upon informed trading as a means to ensure that the prices determined in the commodity markets are as efficient as possible.[10] Individuals and entities that have information that derives from their business activity, including farmers, bankers, miners, drillers, gas suppliers, refiners, and intermediaries, continuously trade on their commercial information in the commodities markets. Trading on such information, especially that which is

[8] Rulemaking, p. 22

[9] The "misappropriation" theory of liability in securities law prohibits the use of material, nonpublic information that is acquired as the result of a breach of confidential relationship such as a newspaper reporter who misappropriates information about upcoming articles from his employer or a lawyer who does the same from his law firm and law firm's clients. See *Carpenter v. U.S.*, 484 U.S. 19 (1987); *U.S. v. Hagan*, 521 U.S. 642 (1997).

[10] The insider trading prohibition of Section 9 of the Commodity Exchange Act is limited to individuals connected with the regulation, self-regulation, or exchange governance of those markets. See Secs. 9(d) & 9(f) of the CEA, 7. U.S.C. §§ 13(d) & (f) (prohibiting Commissioners and Commission employees and members or employees of any governing board or committee of a board of trade, registered entity, or registered futures association to trade on the basis of material nonpublic information obtained through special access related to the performance of their duties).

proprietary and generated through experience and research of the companies in an industry, is the basis for market efficiency.[11]

The Rulemaking suggestion that liability could be based upon the possibility that a statement is "incomplete" threatens the price discovery process and the efficiency that results from it. Competitors should not be put in the predicament created by this interpretation in which they question whether they can trade on information they have acquired proactively or through their commercial activities. In effect, this information is proprietary and gives the holder of that information certain advantages that one would expect them to use in decision making and negotiation. The omission standard outlined in the Rulemaking could very likely discourage market participants from investing in the collection of information.

Collection and analysis of commercially relevant information, as well as having the ability to trade on and profit from it, is critical to any entity in every industry and business pursuit (with the exception of the publicly traded securities markets, for reasons described above). A favorable price that may result from possessing such information, or the profit that may result, are not the bounty of manipulation but rather are the just reward for uncovering and interpreting the information to enhance one's competitive position.

As with other commodities markets, the efficiency of petroleum markets is enhanced as companies who deal in these markets and their traders make calculated transactions to profit from information that stems from their commercial activity. The collection and interpretation of information relevant to the price of a transaction comes through skill and investment. A prohibition that may result in the prosecution of omissions discourages the collection and profitable use of market information in decisions regarding supply, transactions, and pricing and could harm market efficiency and impair market function. If companies and their traders can no longer profit from the information they have collected, which would be the case if they were compelled to convey it because it constitutes a material omission, they lose their incentive to

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[11] Fama, Eugene F., "*Efficient Capital Markets: A Review of Theory and Empirical Work*", The Journal of Finance, 25, no. 2, (1970), 383-417, explains the strong and weak form of the efficient markets hypothesis, with trading on inside information yielding the strongest form of market efficiency.

collect information and may consequently exit the market and seek to transact offshore or in more opaque markets.

Too broad an interpretation of what constitutes "misleading" to include material omissions is likely to give rise to *ex post* opportunistic behavior on the part of counterparties who did not possess the allegedly omitted information and are unhappy with the deal they struck. Claims by less informed counterparties are likely to be a common theme among complaints received by the Commission. In order to avoid such a result, and increased regulatory scrutiny, entities may discourage voluntary disclosures of any kind out of concern that a failure to fully disclose material information could lead to liability. This ultimately results in *less* informed market participants, inefficient price discovery, and less liquid wholesale markets.[12]

V. Conclusion

In order to encourage pro-competitive behavior, it is important that the standard for liability should be no less than specific intent to manipulate market prices. The use of commercially sensitive information – disclosed or undisclosed – as a basis for evaluating and executing purchases or sales in wholesale markets for petroleum should not be viewed as originating from an intent to manipulate the market. A standard that allows liability for mere recklessness further discourages disclosure of information for concern that uncertainty regarding the completeness or accuracy of the information. An interpretation of the securities law precedent that does not appropriately consider factors particular to the market can impose significant costs on market participants and has the potential to affect market function and quality, which can have far-reaching, long-run effects.

Finally, the Advance Notice asks how it should approach the rulemaking to avoid regulatory overlap with the CFTC. Having testified on, deliberated upon, and written about jurisdictional boundaries of the CFTC as they relate to the over-the-counter markets and the asset or commodity markets underlying them, it is my hope that the Commission will narrow the focus of the rule tightly upon manipulative and deceptive conduct in the wholesale petroleum markets.

[12] See also S. Brown-Hruska and R. Zwirb, "Legal Clarity and Regulatory Discretion: Exploring the Law and Economics of Insider Trading in Derivatives Markets," *Capital Markets Law Journal* 2 (3), (Oxford University Press, London), 2007, 245-259

By doing so, the rules will appropriately complement the jurisdiction of the CFTC and will avoid overlap that would result if accompanied by an assertion of authority into financial market transactions that would give rise to legal uncertainty in the exchange-traded and over-the-counter derivative markets.

With respect to the issue of exclusive jurisdiction, the Commission's assertion of jurisdiction regarding manipulative activity with the CFTC appears to rely heavily upon the legal analysis that FERC is employing in support of an identical posture in that agency's enforcement action against Amaranth Advisors.[13] I would just note that the jurisdictional issue in that case will most probably be decided by a United States Court of Appeals, and that the consistent line of case law authority stretching back to 1975 has consistently upheld the preemptive effect of the Commodity Exchange Act's exclusive jurisdiction provision in similar circumstances. This history strongly argues against the position that FERC is advocating, and that the Commission is adopting, and thus creates potential legal uncertainty for the Commission's position going forward.[14]

Moreover, it is my view that both the Commission and FERC in support of their view on jurisdiction appear to be relying upon a legal interpretation of the *Ken Roberts* matter (*FTC v. Ken Roberts*, 276 F.3d 583 (D.C. Cir. 2001), which held that the Commission's authority under the FTC Act to investigate deceptive marketing of commodities trading instruction did not conflict with the CFTC's exclusive jurisdiction under Section 2(a)(1)(A) of the Commodity Exchange Act. As the Solicitor General of the Department of Justice observed in connection with the petition for a writ of *certiorari* to the U.S. Supreme Court in that matter, *Roberts* simply stands for the proposition that other agencies may share power with the CFTC over activities that lie *outside* of § 2(a)(1)(A), but within other jurisdictional authority of the CFTC.[15]

In other words, while the Commodity Exchange Act contemplates the sharing of jurisdiction with other agencies such as the FTC with respect to activities that do not involve the actual sale

[13] *Amaranth Advisors* LLC, 120 F.E.R.C. ¶ 61,085 (July 26, 2007) (show cause order).

[14] For a more comprehensive analysis of the exclusive jurisdiction issue in general and its application to the Amaranth matter in particular, *see* CFTC & FERC vs. Amaranth: Doing the Sister Regulator Act," *Futures & Derivatives Law Report*, Oct. 2007, Vol. 27, Issue 9.

[15] *Brief for the Respondent in Opposition to Petition for Writ of Certiorari*, No. 01-1772 (Aug. 2002).

of commodity futures or options, it does not envision such overlapping authority with respect to "accounts, agreements and transactions" "involving" futures traded on markets regulated by the CFTC. Thus, where manipulative activity occurs in connection with the buying and selling of futures contracts, such as those for petroleum and other energy contracts that are traded on the NYMEX, the CEA contemplates the CFTC to be the sole regulator to the exclusion of all other regulators. As Judge Frank Easterbrook noted in *Chicago Mercantile Exchange v. S.E.C.*:

> An instrument either is or is not a futures contract. If it is, the CFTC has jurisdiction; if it is not, the CFTC lacks jurisdiction; if the CFTC has jurisdiction, its power is exclusive.[16]

As nothing in the EISA suggests that Congress intended to limit or supersede the CFTC's exclusive jurisdiction—and even had Congress demonstrated such an intent, it would have required an amendment to the Commodity Exchange Act to carry out that intent—I believe that it is incumbent upon the Commission to respect both the letter and spirit of this important provision of the Commodity Exchange Act.

Respectfully submitted,

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[16] 883 F2d 537, 548 (7th Cir. 1989).