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May 22, 2009

Mr. Donald S. Clark
Secretary
Federal Trade Commission
Market Manipulation Rulemaking
Room H-135 (Annex G)
600 Pennsylvania Avenue, N.W.
Washington, DC 20580

Re: Market Manipulation Rulemaking, P082900
Prohibitions on Market Manipulation and False Information, Section 811 of
Subtitle B of Title VIII of the Energy Independence and Security Act of 2007

Dear Mr. Clark:

The Committee on Futures and Derivatives Regulation (the "Committee") of the New York City Bar Association (the "Association") is pleased to provide this comment on the revised notice of proposed rulemaking of the Federal Trade Commission ("Commission"), 74 Fed. Reg. 18304-18329, Apr. 22, 2009, to implement Section 811 of Subtitle B of Title VIII of the Energy Independence and Security Act of 2007 (hereinafter, the Commission's "Revised Notice"). The Committee also incorporates herein by reference its June 23, 2008 and October 22, 2008 comment letters in this rulemaking because many of their points remain relevant to the consideration of the Revised Notice.

The Association is an organization of over 23,000 members. Most of its members practice in the New York City area. However, the Association also has members in nearly every state and over 50 countries. The Committee consists of attorneys knowledgeable in the regulation of futures contracts and other derivative instruments and experienced in the representation of futures industry participants and registrants. It has a history of publishing reports analyzing regulatory issues critical to the futures industry and related activities. The Committee's interest in the proposed rulemaking arises from its potential effect on participants in spot and derivatives markets. The Committee appreciates the opportunity to comment.

The Committee commends the Commission and its staff on their diligence and the thoughtful and rigorous analysis of the Revised Notice. The Committee understands that the central purpose of the revised proposed Rule is to prohibit fraudulent and deceptive conduct that would corrupt the integrity of market prices for wholesale crude oil gasoline and petroleum distillates (collectively, "the wholesale petroleum markets"). The Committee believes that the revised proposed Rule and the Commission's alternative Rule language are substantial improvements over the original proposed Rule. While the Revised Notice raises many issues for further consideration, the Committee confines its comment to three points concerning the elements of scienter and price effects. First, certain aspects of the Revised Notice are inconsistent or create ambiguity with respect to the otherwise relatively clear scienter standard. Second, although the Revised Notice makes clear that Section 317.3(b) should not be read or applied to create any new disclosure obligations in the wholesale petroleum markets, a serious question remains whether it is efficacious even to include a specific standard with respect to omissions when there are no preexisting disclosure obligations among participants in the wholesale petroleum markets. Third, the Committee continues to believe that any rule adopted under the banner of "anti-manipulation" necessarily must require that a person act with an intent to corrupt market pricing or otherwise to cause market prices to be false, fictitious and artificial and that there be proof of such a price effect or, in the case of an attempted, but unsuccessful manipulation, the likelihood of such a price effect from the proscribed conduct.

A. <u>The Revised Proposed Rule and the Alternative Rule Language</u>

The Commission's Revised Notice sets forth both a revised proposed Rule and alternative Rule language. The revised proposed Rule provides:

It shall be 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; 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.[1]

[1] This provision of the revised proposed Rule, therefore, sets forth conduct that would be manipulative or deceptive, pursuant to Section 811.

The Commission's alternative Rule language is as follows:

> It shall be 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.
>
> * 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.

B. The Scienter Standard

The Committee understands that the inclusion of the words "knowingly" in revised proposed Rule Section 317.3(a) and "intentionally" in Section 317.3(b) is intended to establish a scienter requirement equivalent to the extreme recklessness standard announced by the Seventh and District of Columbia Circuit Courts of Appeals that governs Securities and Exchange Commission ("SEC") Rule 10b-5, 17 C.F.R. 240.10b-5. That mental intent standard requires a showing that a person's false or deceptive statements or acts were made or committed with an intent to deceive or defraud because the revised proposed Rule requires a showing that the person "knew or must have known" that his or her conduct was fraudulent or deceptive. The inclusion of the word "intentionally" in Section 317.3(b) also is intended to make clear that omissions are actionable only where it can be shown that the person made a false or misleading statement by intentionally omitting material facts from the statement when he or she knew or must have known that such omission would render the statement fraudulent or deceptive. Thus, the word "intentionally" in Section 317.3(b) means that a person *intended* to mislead by *intentionally* omitting material information from the statement. Under this standard, statements and conduct that are false or misleading by virtue of mistake, inadvertence, thoughtlessness, negligence, confusion, gross negligence and the like are not actionable.

Several aspects of the Revised Notice, however, hamper the clarity of this scienter standard. One is the reference to "constructive knowledge" in the definition of "knowingly." "Constructive knowledge" as a legal standard typically refers to knowledge that is imputed to a person as a matter of law by virtue of the person's access to information, even though he or she may not be actually cognizant of it. "Constructive knowledge" thus often is applied to hold a person accountable for information that he or she "should have known," even if he or she did not. The legal concept of "constructive knowledge," accordingly, is inconsistent with a "knew or must have known" scienter standard. The Committee respectfully submits, therefore, that the definition of "knowingly" should omit reference to "constructive knowledge."

The revised proposed Rule's retention in Section 317.3(a) of the "operates or would operate as a fraud or a deceit" language, albeit in a different context from its use in the original proposed Rule, also encumbers the clarity of the Rule because that language has been uniformly interpreted under the federal securities laws to establish a *non-scienter* standard.[2] Such language is thus out of kilter with a "knew or must have known" standard. The Committee suggests that greater clarity is achieved by replacing Section 317.3(a)'s "operates or would operate as a fraud or deceit upon any person" language with the simpler and clearer words "defrauds or deceives any person."

C. <u>Omissions</u>

As much as the Commission and its staff have labored to be clear that the proposed anti-manipulation rule does not create any new disclosure obligations in the wholesale petroleum market, where typically none exist, the inclusion of a specific omission standard in the revised proposed Rule is still problematic. Where, as here, market participants generally have no disclosure obligations to other participants, once the premise of a disclosure duty is formally implicated by a rule, discerning its boundaries can be difficult. For example, if a party in negotiating a purchase of crude oil voluntarily discloses to its counterparty its reason for the purchase, even though such disclosure was not required by law and made gratuitously and without any perception that it was material to the transaction, when, if ever, does the party making the statement have a duty to update it if its reasons for the purchase change before the transaction is entered into? Currently, market participants rightly would not think there is any duty to update, but, once disclosure obligations are embedded in a rule, that conclusion becomes less clear. The potential for legal uncertainty and for it to become a platform for vexatious litigation by parties wishing relief from unfavorable deals outweighs any marginal value of promulgating an omissions/disclosure rule in the wholesale petroleum markets. If the Commission's experience later proves otherwise, it could then amend the Rule to add an express standard with respect to omissions. The Revised Notice recognizes that the origin of Section 317.3(b)'s omissions standard is SEC Rule 10b-5 governing securities markets. The lack of a need for an omissions/disclosure rule in the wholesale petroleum market contrasts starkly with the absolutely essential need for it in securities markets where disclosure standards are foundational to the "pro-disclosure" market structure established by the federal securities laws. The Committee, accordingly, recommends that the Commission not adopt Section 317.3(b).[3]

D. <u>Price Effects and Intent to Corrupt Market Pricing</u>

1. The Committee continues to believe that proof of intent to corrupt the integrity of market pricing processes or an intent otherwise to cause false, fictitious and artificial market

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2 E.g., Aaron v. SEC, 446 U.S. 680 (1980); SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963).

3 The alternative Rule language would seem to ameliorate this issue by not specifically addressing omissions. The alternative Rule language, however, could be improved by omitting the language in the second paragraph that is intended to denigrate the importance of whether the conduct was likely to succeed in defrauding or deceiving the target. Such language is problematic in application because it is entangled with and prejudges the merits. In cases based on circumstantial evidence, which many manipulation cases are, the likelihood that conduct would defraud or deceive a target may be probative of the merits of the central issue of whether one can infer that a person acted with an intent to defraud or deceive.

prices must be a necessary element of any anti-manipulation rule. (See Point A at pages 3 - 7 of the Committee's October 22, 2008 letter.) As other anti-manipulation statutes reflect, the touchstone for determining whether any conduct is an unlawful "manipulation" is its effect on the integrity of market pricing. It is contradictory to the purpose of an anti-manipulation rule to divorce a violative conduct from its effect on the integrity of pricing. The Committee, therefore, recommends that the Commission revise Section 317.3(a) to make intent to corrupt market pricing an element of the offense by adding at the end the words "with the intent to corrupt the integrity of market pricing or otherwise to cause false, fictitious, or artificial market prices."

2. The Revised Notice expresses conflicting sensibilities by, on the one hand, declaring that the existence of a price effect from proscribed conduct is not an element of proof of a violation, but, on the other hand, requiring in Section 317.3(b) proof that violative conduct distorted or tended to distort "market conditions" for covered products. Tying violative conduct to effects on "market conditions" is an imprecise and poor substitute for effects on market pricing. The distortion of market conditions is relevant only to the extent it undermines the integrity of pricing. Actions that result in distortions of regular market conditions but do not corrupt the integrity of market pricing should not be actionable.

3. The Commission's aversion to making a price effect an element of a violation appears grounded in its concern that fraudulent conduct specifically intended to distort prices should not go unpunished simply because it fails to succeed in causing a distortion. In this, the Commission would appear to be concerned with assuring that its Rule will reach attempted manipulations as well as perfected manipulations. That concern is better addressed by creating a specific prohibition of attempted manipulation (e.g., "knowingly engage or attempt to engage in any act . . ."), not by jettisoning the traditional requirement that there be an intent to corrupt market pricing. Consistent with the foregoing, the Committee recommends that the Commission make clear that violation of Section 317.3 requires a showing that the fraudulent and deceptive conduct corrupted market pricing or otherwise caused false, fictitious, or artificial market prices, or, in the case of an attempted manipulation, had a likelihood of causing such an effect.

4. The statement in the Revised Notice that an example of a violation of Section 317.3(a) would include "false statements in the context of bilateral and multilateral communications with any market participant or other person – who may serve as a conduit for the dissemination of information, or who might act on the information – such as traders, suppliers, brokers, or agents; federal, state, or local governments; and government or private publishers" is overbroad. That statement, read literally, could contemplate that any false statement in a bilateral communication with a counterparty violates the Rule, even if it had no effect on market prices and could not have had any. The Commission's anti-manipulation rule should not be so broad as to reach to every claim of garden-variety fraud in private commercial transactions, when they have no material effect on market pricing. An anti-manipulation rule, rather, should focus on preventing conduct that corrupts the integrity of market pricing. The Committee also respectfully submits that market participants should not be held to consider in the normal course of business that every trader, supplier, and the like is a "conduit for the dissemination of information," such that an inference can reasonably be drawn that any communication to any trader, supplier or the like should be treated as an intent to disseminate or a dissemination of information broadly throughout the market. The customs and practices of the marketplace do not support such an inference.

The Committee thanks the Commission for this opportunity to comment.

Very truly yours,

Michael S. Sackheim
Chair
Committee on Futures and Derivatives Regulation

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¶ These members of the Committee did not participate in this comment letter.
* This member is the Chair of the Committee's Ad Hoc Sub-Committee on the FTC's Market Manipulation Rulemaking.