MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

December 28, 2010

**Via Electronic Submission:** http://comments.cftc.gov

Commodity Futures Trading Commission
c/o David A. Stawick, Secretary
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

**Re: Notice of Proposed Rulemaking on the Prohibition of Market Manipulation. RIN No. 3038-AD27.**

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] submits these comments in response to the Commodity Futures Trading Commission's Notice of Proposed Rulemaking on the Prohibition of Market Manipulation (the "Notice"). We appreciate the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its proposed rules to implement new anti-manipulation authority in Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). We respectfully submit comments on the Commission's proposed two rules:

(i) Proposed Section 180.1, implementing Section 6(c)(1) of the Commodity Exchange Act, as amended (the "CEA"), and promulgated pursuant to Section 753 of the Dodd-Frank Act ("Section 180.1");[2] and

(ii) Proposed Section 180.2, implementing Section 6(c)(3) of the CEA, as promulgated pursuant to the Commission's general rulemaking authority under Section 8(a)(5) of the CEA ("Section 180.2").[3]

MFA and its members support the Commission's mission of deterring and preventing price manipulation and other disruptions to market integrity. We depend on honest markets with prices that accurately reflect supply and demand. We look forward to working closely with the Commission to

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Prohibition of Market Manipulation, 75 Fed. Reg. 67,657 (Nov. 3, 2010) (to be codified at 17 C.F.R. pt. 180).

[3] *Id.*

promulgate rules that serve the public interest by preserving the liquidity of the futures and derivatives markets. Thus, these markets can continue to provide a means of managing price risks, discovering prices and disseminating price information through liquid, fair and financially secure trading practices.[4]

## I. Summary

MFA urges the Commission to adopt rules and guidance that effectively clarify the rights and obligations of market participants. We believe that greater guidance in this area will clarify the lines between permissible and impermissible conduct and allow market participants to develop proper internal controls. To that end, we recommend that:

1) The Commission should not import SEC Rule 10b-5 precedent to trading in the futures and derivatives markets;

2) No new duties should be implied from the Commission's proposed rule beyond those to which participants in the futures and derivatives markets would otherwise be subject to by agreement or by operation of common law;

3) In the alternative, the Commission should adopt a specific intent level of scienter necessary to violate its proposed Section 180.1, or the Commission should at a minimum impose an "extreme recklessness" level of scienter; and

4) The Commission should clarify that Section 6(c)(3) of the CEA, as well as proposed Section 180.2, do not provide the Commission with any new enforcement authority beyond extending the Commission's anti-manipulation authority to swap transactions.

## II. The Commission's Proposed Section 180.1

### A. The Commission Should Not Employ Rule 10b-5 Precedent to Trading in the Futures and Derivatives Markets

We believe that the Commission should not employ the judicial precedent and legal standards under Rule 10b-5 to trading in the futures and derivatives markets. The Commission itself recognized that there are critical differences between the securities markets and the futures and derivatives markets when it stated in its proposing release that the securities laws and its precedents would "guide, but not control" the Commission and that the Commission will take into account the "purposes of the CEA and the functioning of the markets regulated by the Commission."[5] MFA believes that Rule 10b-5 case law is tailored to the structure of the securities markets, which is significantly different from the futures and derivatives markets. We are concerned that ignoring these differences would hinder market participants' ability to manage and assume price risks, discover prices and disseminate pricing information.

The futures markets have primarily served the public interest by providing a means for managing and assuming price risks, discovering prices and disseminating pricing information through the

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4 *See* 7 U.S.C. § 5(a).

5 Prohibition of Market Manipulation, 75 Fed. Reg. 67,657, 67,659 (Nov. 3, 2010).

trading in liquid, fair and financially secure trading facilities.[6] Securities markets, however, serve an entirely different purpose in that they promote the raising of capital. As such, the underlying policy on antifraud protection in each market has developed for different reasons. Rule 10b-5 standards and case law are based on disclosure duties associated with the purchase and sale of securities. Consistent with the SEC's policy of protecting investors, the disclosure of issuer-specific information generally is aimed at preventing issuers from taking advantage of investors by attempting to give all market participants equal access to material information about their investments. Hence, those who come into possession of material, nonpublic information subject to a duty may not then trade on that information without running afoul of the securities laws.[7]

The duties that exist as a result of the traditional relationships between securities market participants, however, are not applicable to the relationships between the sophisticated commercial and institutional entities in the futures and derivatives space. These entities have the resources, sophistication, experience and bargaining power to negotiate terms and conditions with their counterparties at arm's length. Additionally, market participants do not evaluate a position in a futures or derivatives contract on the basis of an "issuer's" disclosure, a concept that has no relevance in the futures and derivatives markets. Market pricing, too, is conceptually different in that price movements of futures contracts traditionally reflect the supply of and demand for the commodity itself, rather than the financial condition of the issuer and its growth prospects.

Antifraud rules in the futures markets are largely meant to protect price discovery and market integrity by prohibiting market manipulation. The Commission has long recognized that information asymmetries inherently exist in futures transactions. However, the Commission considers such asymmetries legitimate, since futures market participants voluntarily accept these terms if they choose to trade.[8] Even beyond this, information asymmetries are legitimate, because effective market hedging, the basic purpose of the futures market, inherently requires the use of proprietary information which is typically not known to all market participants.[9] Accordingly, the Commission has not applied a separate trading standard to retail market participants. We respectfully urge the Commission to craft a rule that takes into account the more limited duties that market participants owe one another in light of the markets' non-reliance on disclosure and the absence of concerns about the misuse of insider information.

Market participants in the futures and derivatives markets need clarity on what legal standards will apply given the significant differences between the securities and futures and derivatives markets. We are concerned that ambiguity with respect to legal standards would increase transaction costs and chill legitimate trading practices. The market as a whole would also suffer from decreased

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6 7 U.S.C. § 5(a).

7 *See Basic* v. *Levinson*, 485 U.S. 224, 108 S. Ct. 978 (1988); *see also U.S.* v. *O'Hagan*, 521 U.S. 642 (1997) (sustaining Exchange Act Section 10(b) liability where a person breached a fiduciary duty to the source of the information); *Carpenter* v. *U.S.*, 484 U.S. 19, 108 S. Ct. 316 (1987) (sustaining liability where a newspaper employee traded on information received for his column prior to publication in violation of his employer's policy that pre-publication content was the property of the newspaper); *cf. Dirks* v. *SEC*, 463 U.S. 646 (1983). *See also* Regulation FD, 17 CFR §243.100 *et seq.*

8 CFTC, *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information*, Submitted to H.R. Comm. on Agriculture and S. Comm. on Agriculture, Nutrition and Forestry, at 54 (1984).

9 *Id.* at 8.

depth and liquidity, especially in the thinly traded markets, since market participants could change their trading behavior to mitigate potential regulatory risk.

### B. The Commission Should Make It Clear that the Proposed Rule Does Not Impose New Duties

We respectfully ask the Commission explicitly to clarify and confirm that Section 6(c)(1) and Section 4c(a)(7) of the CEA do not impose any new duties of disclosure, inquiry or diligence, other than those that exist or are created under contract, under other laws or by operation of common law. Under CEA Section 4c(a)(7), it is:

> unlawful for any person to enter into a swap knowing, or acting in reckless disregard of the fact, that its counterparty will use the swap as part of a device, scheme, or artifice to defraud any third party.

MFA is concerned that without the Commission's clarification, the mere "recklessness" standard in both Section 4c(a)(7) and proposed Section 180.1 could impose new duties of inquiry or diligence.

This clarification is appropriate in the context of different relationships between market participants. The Commission recognized this distinction in its landmark 1984 study entitled "A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information":

> In futures trading, as in the trading of securities, fiduciary relationships are established along the trading chain from the public customer to the executing broker. However, unlike the purchase or sale of securities, where the subject of the transaction—the corporate security itself—carries with it a fiduciary relationship between the shareholder and the corporate insider, the futures transaction does not create such a fiduciary relationship between an insider and the person on the opposite side of the trade.[10]

We believe the Commission's observations from the 1984 study remain relevant today and that 26 years of reliance on the Commission's findings should not be overturned without careful consideration of the ramifications. In securities laws, duties flow from the structure of the parties' relationships, such as relationships between a broker-dealer and customer, insiders and the public. The corporate insider may not misappropriate information he or she has received to benefit himself to the disadvantage of the outside investor. However, parties in the futures and derivatives markets are in a different position and thus do not have similar duties. The typical party engages in arm's-length transactions standing in equal positions to one another as counterparties. Because of these fundamental distinctions, we believe the Commission should explicitly clarify that no new duties flow from any of the proposed rules beyond those traditionally understood.

MFA supports the Commission's clarification that nothing in proposed Section 180.1 "shall be construed to require any person to disclose . . . nonpublic information that may be material to the market price, rate, or level of the commodity transaction, except as necessary to make any statement made

[10] *Id.* at 55-56.

to the other person . . . not misleading in any material respect."[11] However, MFA believes the Commission should additionally clarify that Section 180.1 will not prohibit market participants from taking positions and trading on material, nonpublic information obtained lawfully within the purview of the common law, the CEA and regulations promulgated pursuant to it. Market participants routinely use futures and derivatives for hedging purposes, and necessarily enter into transactions with proprietary information regarding their assets and liabilities. It would completely undermine their ability to effectively hedge price risks if they could not trade on the basis of this proprietary information legitimately obtained in the course of their regular business. MFA's request for clarification is consistent with the Commission's position stated in its 1984 study:

> The 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 on knowledge of one's own position were permissible.[12]

Without this clarification, the Commission puts into question a practice that has long been one of the futures and derivatives markets' most important roles in commerce.

### C. The Commission Should Clarify the Scope of the Proposed Rule Under Section 6(c)(1) and the Commission's Already Existing Anti-Manipulation Authority Under CEA Section 9(a)(2) and Broad Antifraud Authority Under CEA Section 4b

MFA seeks clarity and additional guidance from the Commission regarding the scope of the proposed rule under Section 6(c)(1) and how it relates to the Commission's anti-manipulation authority under Section 9(a)(2) and broad antifraud authority under Section 4b.

The Commission has historically relied on other provisions of the CEA, including Section 9(a)(2) and the prior Section 6(c), in its administrative and civil enforcement actions against fraud-based manipulation and attempted manipulation, requiring some form of deception, such as reporting of false prices or the making of false statements. Additionally, subsection 6(c)(1)(B) of the Dodd-Frank Act states that nothing in the new law shall affect, or be construed to affect, the applicability of CEA Section 9(a)(2). The Commission has also expressly stated in its proposing release that its authority under Section 9(a)(2) remains unaffected by the proposed rule and thus will remain available as an enforcement mechanism which may be used in concert with the proposed rule.[13]

It is unclear to market participants whether or to what extent the proposed rule under Section 6(c)(1) of the CEA, other than to extend its antifraud authority to swap transactions, will grant to the Commission any new antifraud authority that it did not already have either under Section 9(a)(2) of the CEA or under the broader antifraud provision, Section 4b of the CEA. This ambiguity causes confusion and uncertainty to market participants who require straightforward guidance about the types of behavior that are prohibited. Market participants faced with overlapping and potentially inconsistent rules

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[11] Prohibition of Market Manipulation, 75 Fed. Reg. 67,657, 67,662 (to be codified at 17 C.F.R. pt. 180).

[12] CFTC, *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information*, Submitted to H.R. Comm. on Agriculture and S. Comm. on Agriculture, Nutrition and Forestry, at 8 (1984).

[13] Prohibition of Market Manipulation, 75 Fed. Reg. 67,657, 67658 (Aug. 12, 2009).

relating to the same activities are likely to reduce their participation because of the risk that activity permitted by one provision may be penalized under another.

From our review and analysis, we believe that the Commission should interpret Section 6(c)(1) merely to clarify and refine the Commission's authority over swaps but should not grant the Commission any new antifraud authority or create any new duties or obligations, and we respectfully urge the Commission to provide such clarification.

### D. The Commission Should Propose a Rule that Requires Specific Intent

Alternatively, if the Commission determines to apply some portions of Rule 10b-5 analysis in this context, MFA urges the Commission to establish a standard of specific intent as the scienter requirement under the Commission's proposed rule, rather than recklessness. We believe a higher scienter standard is appropriate for many reasons.

First, we note that the Commission's proposed rule is essentially an antifraud rule. By its own terms, Section 180.1 prohibits the "[u]se or employ[ment], or attempt[ed] . . . use or employ[ment], [of] any *manipulative* device, *scheme*, or *artifice* to *defraud*."[14] The Supreme Court held that "to use or employ" and "fraudulent or deceptive," as used in Section 10(b) of the Exchange Act, indicates that Congress intended to prohibit only "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting [price]" in *Ernst & Ernst* v. *Hochfelder*.[15]

Second, we believe the nature and structure of the parties' relationships in the futures and derivatives markets should require a specific intent standard. Parties to futures transactions are generally sophisticated and have the resources and bargaining power to protect themselves. Similarly, parties to swap transactions, "Eligible Contract Participants," as the term is defined in the CEA ("ECPs"), have the same ability to access and evaluate relevant information and to negotiate their own terms. There is no fiduciary relationship between two sophisticated commercial or institutional parties that would warrant heightened duties or increased regulatory protection. While retail participants do have access to the futures markets, unlike the securities markets, no single "issuer" controls access to information in the futures and derivatives markets, and the pricing of futures is reflective of supply and demand, rather than valuation based on such financial disclosure.

Third, we believe a scienter standard that is lower than specific intent could chill legitimate trading activity. A specific intent requirement would appropriately target situations in which parties actively seek to manipulate market prices. Transactions in the futures and derivatives markets have the inherent ability to affect market prices. To impose a lesser standard than specific intent will inhibit market participants from engaging in lawful competitive behavior that ultimately will affect market prices. Rather than chilling legitimate trading that adds value to the markets by lowering spreads and adding liquidity and depth, we believe the Commission should craft an enforcement rule that describes the behavior deserving punishment.

MFA respectfully urges the Commission to adopt a specific intent standard as it is also consistent with the traditional elements required to prove attempted manipulation. Courts have held that to satisfy a claim for attempted manipulation, the Commission must show: (1) an intent to affect market

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[14] Prohibition of Market Manipulation, 75 Fed. Reg. 67,657, 67,662 (to be codified at 17 C.F.R. pt. 180) (emphasis added).

[15] *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197-99 (1976).

prices and (2) an overt act in furtherance thereof.[16] We urge the Commission to adopt the specific intent standard and confirm that the traditionally required elements to prove attempted manipulation, stated above, remain unchanged. This ensures that the prohibitions under the Commission's antifraud rule do not sweep more broadly than do other comparable antifraud rules.

However, if the Commission declines to impose a specific intent requirement, we believe it should be guided by the Federal Trade Commission's ("FTC") anti-manipulation rules and impose, at a minimum, an "extreme recklessness" standard.[17] The "extreme recklessness" standard carries with it the notion that a person is acting willfully to carry out his or her ultimate objective. MFA notes that almost all the circuits that have considered the level of scienter required for a violation of Rule 10b-5 have adopted the extreme recklessness standard.[18] If the Commission declines to adopt a specific intent requirement, we believe the proposed rule should at least require 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 so obvious that the actor must have been aware of it."[19]

## III. The Commission Should Clarify that Its Proposed Section 180.2 Does Not Articulate Any New Standards or Obligations

The Commission's Proposed Section 180.2 is consistent with the recent judicial precedent established in the Second Circuit that conduct giving rise to a manipulation charge need not be intrinsically fraudulent or otherwise illegal in order for liability to attach.[20] Other than extending its anti-manipulation authority to swap transactions, the Commission should clarify that it is not articulating any new standards or obligations under Section 6(c)(3) of the CEA and proposed Section 180.2 with regard to trading practices that attempt to exploit the illiquidity of markets and are intended to move prices.

MFA supports the Commission's statement that it is reaffirming the traditional four-part test needed to sustain a manipulation charge.[21] However, MFA strongly believes the Commission should not create a "conclusive presumption" that a price is artificial without proof of *specific intent* to move

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16 *U.S. Commodity Futures Trading Comm'n* v. *McGraw-Hill Cos.*, 507 F. Supp. 2d 45, 51 (D.D.C. 2007) (stating "Attempted manipulation is demonstrated by the intent to affect market prices and some 'overt act' in furtherance thereof.") (internal citations omitted).

17 Prohibitions on Market Manipulation, 74 Fed. Reg. 40,686, 40,691-92 (Aug. 12, 2009).

18 *See Phillips* v. *LCI Int'l, Inc*., 190 F.3d 609, 621 (4th Cir. 1999); *SEC* v. *Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992); *Hollinger* v. *Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc); *Ross* v. *Bank South, N.A.*, 885 F.2d 723, 730 n.10 (11th Cir. 1989); *Hackbert* v. *Holmes*, 675 F.2d 1114, 1118 (10th Cir. 1982); *Broad* v. *Rockwell*, 642 F.2d 929, 961 (5th Cir. 1981) (en banc); *McLean* v. *Alexander*, 599 F.2d 1190, 1197 (3d. Cir. 1979); *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *see also Greebel* v. *FTP Software*, 194 F.3d 185, 198 (1st Cir. 1999); *Camp* v. *Dema*, 948 F.2d 455, 461 (8th Cir. 1991).

19 *Sundstrand Corp.* v. *Sun Chem. Corp*., 553 F.2d 1033, 1044 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977) (emphasis added).

20 *In re DiPlacido*, 2008 WL 4831204, Comm. Fut. L. Rep. ¶ 30970 (CFTC 2008), *aff'd in pertinent part*, *DiPlacido* v. *Commodity Futures Trading Comm'n*, 2009 WL 3326624, Comm. Fut. L. Rep. ¶ 31,434 (2d Cir. 2009), Comm. Fut. L. Rep. (CCH) ¶ 20,271 at 21,477.

21 Manipulation cases involving "corners" and "squeezes" produced a framework requiring the Commission establish: "1) That the accused had the ability to influence market prices; 2) that they specifically intended to do so; 3) that artificial prices existed; and 4) that the accused caused the artificial prices." *Prohibition of Market Manipulation*, 75 Fed. Reg. 67,657, 67,660 (2010).

prices.[22] This would constitute an overly aggressive interpretation of judicial precedent like *DiPlacido* and cast too wide a net over legitimate trading activities that are not similarly intended to create artificial prices. There are a variety of *bona fide* commercial reasons for conducting trades that may appear on their face to lack economic rationale but which are not specifically intended to move prices (*e.g.*, hedging activities during the closing period). Indeed, the Second Circuit did not believe the four-part test "collapsed," as DiPlacido argued, because the "Commission stated that 'violating bids and offers—*in order to influence prices*,' was 'sufficient to show manipulative intent,'" adding:

> [The Commission's] finding of intent thus depended not merely on DiPlacido's having violated bids and offers, but also on taped conversations signaling *manipulative intent* and the ALJ's finding that DiPlacido's denial of intent lacked credibility. Further, the Commission cited evidence (including expert testimony) that artificial prices were a "reasonably probable consequence" of DiPlacido's large trades made during the Close in an illiquid market. Thus, the Commission carefully applied *all four elements of the traditional test*. . . .[23]

The Commission should thus read *DiPlacido* as cautioning against collapsing any of the four elements of the traditional four-part test.

In a market that at times has been called "volatile and esoteric," we believe that market participants should not be subject to regulations reflecting those same qualities.[24] MFA believes that the Commission is uniquely positioned to provide much needed clarity on an uncertain and confused body of the law surrounding manipulation.

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22 *Id.* at 67,661.

23 *DiPlacido* v. *Commodity Futures Trading Comm'n*, 2009 WL 3326624 at *3, Comm. Fut. L. Rep. ¶ 31,434 (2d Cir. 2009) (emphasis added).

24 *Merrill Lynch* v. *Curran*, 456 U.S. 353, 355-56 (1982).

MFA thanks the Commission for the opportunity to provide comments regarding the proposed rules on its new anti-manipulation authority.

We would be pleased to discuss any questions or comments the Commission or its staff might have regarding this letter. Any questions about this letter may be directed to Jennifer Han or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director,
General Counsel

cc: The Hon. Gary Gensler, CFTC Chairman
The Hon. Michael Dunn, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner