

January 3, 2011

Via Online Submission

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

Re: COMMENTS OF COALITION OF PHYSICAL ENERGY COMPANIES
Prohibition of Market Manipulation RIN Number 3038-AD27

Dear Mr. Stawick:

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act")¹. The Act amended the Commodity Exchange Act ("CEA")² to, *inter alia*, provide for pervasive regulation of swaps markets. Among the amendments to the CEA, Dodd-Frank added provisions concerning Commodity Futures Trading Commission ("CFTC" or the "Commission") anti-manipulation authority, including a prohibition regarding false reporting.³ On November 3, 2010, a Notice of Proposed Rulemaking ("NOPR") issued by the Commission was published in the Federal Register which contained proposed rules addressing the anti-manipulation authority contained in Dodd-Frank.⁴

The Coalition of Physical Energy Companies ("COPE")⁵ supports the Commission's role in policing derivatives markets to prevent manipulation and sanction those that manipulate or attempt to manipulate the markets. As such, COPE generally supports the proposed rules and the intent of Congress in passing the enabling legislation. COPE is less concerned about the intent

¹ Public Law No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank").

² 7 U.S.C. 1 *et seq.*

³ Dodd-Frank § 753.

⁴ Prohibition of Market Manipulation, 75 Fed. Reg. 67657 (November 3, 2010) ("NOPR").

⁵ The members of the Coalition of Physical Energy Companies are: Apache Corporation; Competitive Power Ventures, Inc.; El Paso Corporation; Iberdrola Renewables, Inc.; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; Shell Energy North America (US), L.P.; and SouthStar Energy Services LLC.

expressed in the regulatory preamble than the proposed regulations themselves. In these comments, COPE will address the following: 1) aspects of the regulatory preamble; 2) proposed revisions to the regulatory text; and 3) the harmonization of these rules with similar rules promulgated by other Federal agencies. COPE's proposed revisions to the regulations set forth in the NOPR are attached as Attachment A hereto.

The Commission Should Make Clear That The Proposed Rules Are Designed To Prevent Fraud in the Context of CFTC Jurisdictional Markets

In the NOPR, the Commission makes clear that it understands Section 753 of Dodd-Frank to prohibit "impairing, obstructing, or defeating the integrity of markets subject to the jurisdiction of the Commission" by actions taken with the "mental state embracing intent to deceive, manipulate or defraud."⁶ In other words, the regulatory language refers to a person engaging in fraud with the intent to interfere with the fair functioning of Commission-jurisdictional markets. Thus, according to the NOPR, Section 753 is an anti-fraud statute.

The Commission notes that CEA Section 6(c)(1) is "patterned after Section 10(b) of the Securities Exchange Act of 1934 ("34 Act").⁷ However, as opposed to the CEA, the regulation of securities markets covered in the '34 Act and other Federal securities law, such as the Securities Act of 1933 ("the Securities Act"),⁸ is focused on disclosure.

For example, in his message recommending the provisions of the Securities Act to Congress on March 29, 1933, President Roosevelt said:

There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business⁹

Accordingly, the Federal securities laws are essentially disclosure statutes.¹⁰ Their fundamental objective is "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails" ¹¹ As explained in 1933 by Professor Felix Frankfurter: "Unlike the theory on which state blue-sky laws are based, the

⁶ Including conduct so reckless the foregoing may be inferred. See NOPR at 67659.

⁷ NOPR at 67658.

⁸ *Securities Act of 1933*, as amended through P.L. 111-229 (2010).

⁹ S. Rep. No. 47 at 6-7 and H. R. Rep. No. 85 at 1-2, 73d Cong., 1st Sess. (1933).

¹⁰ Charles J. Johnson, Jr. and Joseph McLaughlin, *Corporate Finance and the Securities Laws* 3 (3d ed. 2004), *supra* note 15, at 7.

¹¹ *Id.* (citing H.R. Rep. No. 73-85, at 1 (1933)).

Federal Securities Act does not place the government's imprimatur upon securities. It is designed merely to secure essential facts for the investor, not to substitute the government's judgment for his own."¹²

Failure to make disclosures as required under the Securities Act also can lead to liability under clause (b) of Rule 10b-5¹³ for the trading markets in securities.¹⁴ Section 11(a) of the Securities Act provides for liability to purchasers if any part of the registration statement filed with the Securities and Exchange Commission, at effectiveness, "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." The registration statement, of course, contains the prospectus disclosure and offering document for the sale of the securities, which, pursuant to the Securities Act's substantive requirements (*see* section 10), is designed to provide the investor all material and relevant information about the security and its issuer. Separately, section 12(a)(2) creates liability for a person who "offers or sells a security [. . .] by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." Subparagraph (b) of Rule 10b-5 similarly makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security."

In contrast to securities markets, commodity markets are *caveat emptor* markets where no duty of disclosure is required and the value of a commodity (for a typically fungible pre-established quality and quantity of a commodity) is dependent on external factors such as supply, demand, weather, delivery location, etc. In the NOPR, the Commission indicates that it has modeled its proposal after SEC Rule 10b-5 "with modification to reflect the CFTC's distinct regulatory mission and responsibilities."¹⁵

COPE appreciates the Commission's attempt to focus this 10b-5 disclosure-based rule on the unique characteristics of the CFTC's marketplace where disclosure is not required. Therefore, the Commission should make clear that, notwithstanding the similarity in the text to rule 10b-5, the proposed rules are solely designed to prohibit and sanction fraud and do not impose any affirmative disclosure or other requirements on market participants. The regulatory text must be directed towards preventing and sanctioning fraud and should not inadvertently capture any other actions.

The Commission Should Clarify the Proposed Regulations Concerning False Statements

The proposed rule contains two stand-alone provisions concerning false statements. COPE believes that the rules should be clarified and made consistent. The proposed rules state

¹² *Id.* (citing F. Frankfurter, *The Federal Securities Act: II*, *Fortune* 53, 108 (August 1933)).

¹³ 17 C.F.R. § 240.10b-5 (2010).

¹⁴ There are important differences between actions for failure to make disclosures required by the Securities Act and Rule 10b-5 actions, including different elements needed to successfully bring an action and different remedies.

¹⁵ NOPR at 67658.

that it is prohibited, in connection with a swap, futures contract, or contract for the sale of a commodity in interstate commerce, to intentionally or recklessly:

Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading; [or]¹⁶

Deliver or cause to be delivered, or attempt to deliver or cause to be delivered, for transmission through the mails or interstate commerce, by any means of communication whatsoever, a false or misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate. Notwithstanding the foregoing, no violation of this section shall exist where the person mistakenly transmits, in good faith, false or misleading information to a price reporting service.¹⁷

The proposed rule also makes clear that "nothing in this section shall be construed to require any person to disclose to another person 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 to the other person in or in connection with the transaction not misleading in any material respect."¹⁸

As the Act and the proposed rule do not require any disclosure of information to the market in general or to counterparties, the very broad provision that prohibits the *making, or attempting to make, any untrue or misleading statement of a material fact* standing alone is vague and confusing. As the Commission has explained, it intends that a scienter requirement be attached to the proscribed actions. As stated by the Commission, "'scienter' in this context refers to a mental state embracing the intent to deceive, manipulate or defraud."¹⁹ However, the regulation as proposed does not limit proscribed acts to such intent. All that is required is that a person intentionally or recklessly made or attempted to make an untrue statement in connection with a swap, futures contract, or contract for the sale of a commodity in interstate commerce. As such, the Commission should clarify that the proscribed acts must be done with the intent to deceive, manipulate, or defraud.

As proposed, the rule lacks several necessary elements for a market participant to clearly understand what is proscribed. First, as explained by the Commission, there must be an intent to deceive, defraud, or manipulate. Second, the statement must be made to the public or a counterparty that is susceptible of being harmed by reliance upon such statement. As the Commission has explained, a statement must be made in a "manner [that is] reasonably calculated to influence market participants."²⁰ Third, as opposed to an attempt at a manipulative scheme, it is vague beyond understanding how a market participant can "attempt" but fail to

¹⁶ *Id.* at 67662

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* at 67659.

²⁰ *Id.* at 67659-60.

make a statement that causes or is intended to cause harm. A statement is either made or not made. If it is not made, nothing has happened. COPE is unaware of examples of "attempted statements," and the NOPR does not provide any beyond indicating that an "overt act" is required. With respect to a statement, COPE would assume the overt act would be the statement itself.²¹

Thus, COPE recommends that the proposed rule be clarified to address the foregoing issues. As such, COPE proposes the following regulatory text for new § 180.1(a)(2) of 17 CFR Part 180:

Make, or cause to be made, any untrue or misleading statement of a material fact or omit to state a material fact necessary in order to make the statements made not untrue or misleading with the intent of deceiving or defrauding other persons or manipulating commodity markets knowing, or acting in reckless disregard of the fact, that such fact or omission renders the statement to be materially false or misleading and will have the foreseeable effect of deceiving or defrauding other persons or manipulating commodity markets.

The foregoing rule would be better aligned with the Act and the statutory intent. Further, it would create common and parallel standards for "statements of material fact" and "reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce." Since these provisions are similar, if not redundant, they should be subject to the same standard to avoid confusion and create a structure conducive to compliance.

The Commission Should Clarify the Proposed Regulations Concerning Fraud

Similarly, two stand alone provisions prohibit fraudulent acts. Those sections state that it is unlawful in connection with a swap, futures contract, or contract for the sale of a commodity in interstate commerce, to intentionally or recklessly:

- (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud; [or]
- (3) Engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person.²²

²¹ For example, the writing of a letter that is not communicated to any other person, and is never sent or disclosed, should not be considered an overt act as no statement has been made, even though the act of writing a letter has been conducted. The concept of attempted statements is fraught with compliance problems. Assume a business person drafted a communication she intended to send to the market but shared it with compliance personnel before doing so. If the communication contained a false statement of a material fact that the compliance personnel detected and deleted, did the business person attempt to make a false statement and commit an overt act, and thus is the compliance person required to report such business person to the CFTC? COPE believes that, rather than evidencing a violation, the foregoing represents a successful compliance process that would be favored by the CFTC.

²² NOPR at 67662.

Although these provisions may be based on separate statutory language, COPE cannot discern any meaningful distinction between the two. Although the NOPR addresses the new language of Section 753 and the pre-existing Commission anti-manipulation authority, it does not describe a basis for a significant difference between proposed subsections 1 and 3 of new section 17 CFR § 180.1(a). According to the NOPR, one provision concerns "the use or employment, or attempted use or employment, of any manipulative or deceptive contrivance for the purpose of impairing, obstructing, or defeating the integrity of the markets subject to the jurisdiction of the Commission."²³ The other provision concerns "effort[s] to influence the price of a swap, commodity, or commodity futures contract that is intended to interfere with the legitimate forces of supply and demand in the marketplace."²⁴ The regulatory text for the two provisions is so similar that they could virtually be substituted for one another. COPE understands them both to prohibit the same fraudulent acts.

Thus, COPE is concerned that the principles of construction used by a court or future Commission could lead to the view that these provisions have two distinct meanings, since it would be logical for the Commission to have intended separate meanings for these two provisions; otherwise, it would have promulgated only one.

In the context of this rule there appears to be no difference between the "use of a manipulative scheme to defraud" and "engag[ing] in a practice or course of business, which operates ...as a fraud...on any person." Since the proposed regulatory text is redundant, the Commission should make clear in the regulatory text what each provision means (since the regulatory text is the most significant element of the Commission's intent, with the preamble only relevant as additional explanation). Since the Commission has made clear that it understands its regulatory mission with respect to Section 753 of Dodd-Frank to be the prohibition of fraud by a person possessing the "mental state to deceive, manipulate or defraud," its rules implementing that section should clearly and concisely state just that. Avoiding redundancy that creates confusion, the Commission should prohibit fraudulent actions possessing the requisite scienter.

COPE recommends the Commission collapse its prohibition of fraud into one clear and concise provision. That provision should read:

Engage in or attempt to engage in any manipulative device, practice, act or course of business to defraud any person;

The foregoing provision does not limit the Commission's authority. It makes clear that there is a singular anti-fraud provision, rather than two potentially redundant and confusing provisions addressing the same topic.

Furthermore, the NOPR also proposes an additional provision (§ 180.2). That provision states:

²³ *Id.* at 67659.

²⁴ *Id.* at 67660.

Other Manipulation

It shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity.

While COPE understands that this provision is intended to address actions other than those proscribed by Section 753, the actions described in the provision appear to be identical to those proscribed by § 180.1. COPE requests that the Commission either delete this provision and indicate that § 180.1 has a statutory basis beyond solely Section 753, or revise this section to materially differentiate it from § 180.1. Unless the Commission makes such a change, market participants will not be on notice as to the activities proscribed by § 180.2.

The Commission Should Clarify The Meaning Of The Term "Recklessly"

In the NOPR, the Commission states that, "consistent with the Supreme Court's interpretation of Exchange Act section 10(b) and SEC Rule 10b-5, a person must act with 'scienter' in order to violate [the proposed Act and regulations]."²⁵ Further, as stated by the Commission, "'Scienter' in this context refers to a mental state embracing intent to deceive, manipulate or defraud, and it includes recklessness."²⁶ COPE supports the Commission's actions to prevent and sanction fraud in derivatives markets. COPE also believes that the Commission's implementing regulations must be clear and not lead to compliance confusion.

In explaining its intent with respect to the inclusion of recklessness, the Commission stated that it will look to 10b-5 precedent to inform its decisions but will adapt its rules to its jurisdictional markets on a case-by-case basis.²⁷ COPE appreciates the Commission's need to flesh out its regulations through experience. However, COPE also believes that the regulatory text (and the regulatory preamble) should be more explicit about what is intended when the concept of recklessness is imported to supplement direct unambiguous intent.

COPE believes that recklessness should only be actionable when a person's actions display a material and significant disregard for their clearly predictable adverse impact on the fair and competitive functioning of Commission-jurisdictional markets. In such circumstances, intent can be inferred. The Commission should make clear that the recklessness contemplated is not recklessness in a tort sense, but rather a business activity so divergent from rational market behavior as to indicate a fraudulent intent.

Thus COPE recommends the following regulatory text:

"Reckless" or "recklessly", as included in this § 180.1, shall mean a person's knowing undertaking of actions which will lead to a predictable and adverse effect on the fair and competitive functioning of Commission jurisdictional markets such that the integrity of such markets will be impaired, obstructed or defeated.

²⁵ *Id.* at 67659.

²⁶ *Id.*

²⁷ *Id.*

The Commission Should Make Clear That It Intends To Implement The Proposed Regulations In A Manner Consistent With The FERC And FTC

Finally, as the proposed regulations will overlap with similar enforcement authority of other Federal agencies having jurisdiction over cash markets for various commodities, the Commission should take care to harmonize its oversight with such agencies. The agencies most relevant to COPE are the Federal Energy Regulatory Commission ("FERC") and the Federal Trade Commission ("FTC"), both of which have 10b-5 based rules.

The FERC and the FTC have used different regulatory text to implement their 10b-5 based rules, but both appear to be attempting to implement similar regulatory regimes.²⁸ Since FERC has jurisdiction over wholesale cash markets for natural gas and power and the FTC has jurisdiction over wholesale cash markets for oil and refined petroleum products,²⁹ their jurisdictions do not overlap. However, since the Commission has jurisdiction over swap markets which have an underlying basis in those cash markets, there is much more of a potential for overlap.

Therefore, COPE requests that the Commission indicate in its final rule that it intends its regulations to be no more broad than those promulgated by the FERC and FTC. Market participants implementing compliance programs should not have to guess whether the rules governing the same activity administered by different agencies proscribe the same behavior. The concept of manipulation should not vary agency by agency.

²⁸ See 18 C.F.R §§ 1c.1 – 1c.2 (2010); 16 C.F.R. §§ 317.1-317.5 (2010).

²⁹ COPE notes that its proposed regulatory language (for example, proposed revised § 180.1(a)(2)) is similar to the approach taken by the FTC in implementing similar statutory language.

Conclusion

COPE requests that the Commission revise the proposed regulations and provide the clarifications requested herein. While it is imperative that the Commission police its jurisdictional markets to prevent fraud, it is also critical that market participants be provided as much clarity and certainty as possible in order for them to comply with the Commission's associated regulations.

Respectfully submitted,

/s/ David M. Perlman

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cc: COPE Members

Attachment A

Clean Version of NOPR Text with COPE-Suggested Text

§ 180.1 Prohibition against manipulation.

(a) It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly:

(1) Engage in or attempt to engage in any manipulative device, practice, act or course of business to defraud any person;

(2) Make, or cause to be made, any untrue or misleading statement of a material fact or omit to state a material fact necessary in order to make the statements made not untrue or misleading with the intent of deceiving or defrauding other persons or manipulating commodity markets knowing, or acting in reckless disregard of the fact, that such fact or omission renders the statement to be materially false or misleading and will have the foreseeable effect of deceiving or defrauding other persons or manipulating commodity markets; or,

(3) Deliver or cause to be delivered, or attempt to deliver or cause to be delivered, for transmission through the mails or interstate commerce, by any means of communication whatsoever, a false or misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate. Notwithstanding the foregoing, no violation of this section shall exist where the person mistakenly transmits, in good faith, false or misleading information to a price reporting service.

(b) Nothing in this section shall be construed to require any person to disclose to another person 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 to the other person in or in connection with the transaction not misleading in any material respect.

(c) Nothing in this section shall affect, or be construed to affect, the applicability of Commodity Exchange Act section 9(a)(2).

(d) "Reckless" or "recklessly", as included in this § 180.1, shall mean a person's knowing undertaking of actions which will lead to a predictable and adverse effect on the fair and competitive functioning of Commission jurisdictional markets such that the integrity of such markets will be impaired, obstructed or defeated.

Attachment A

Redline Version of NOPR Text with COPE-Suggested Text

§ 180.1 Prohibition against manipulation.

(a) It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly:

(1) ~~Use or employ,~~Engage in or attempt to ~~use or employ,~~engage in any manipulative device, ~~scheme, or artifice~~practice, act or course of business to defraud any person;

(2) Make, or ~~attempt~~cause to ~~make~~be made, any untrue or misleading statement of a material fact or omit to state a material fact necessary in order to make the statements made not untrue or misleading with the intent of deceiving or defrauding other persons or manipulating commodity markets knowing, or acting in reckless disregard of the fact, that such fact or omission renders the statement to be materially false or misleading and will have the foreseeable effect of deceiving or defrauding other persons or manipulating commodity markets; or,

~~(3) Engage, or attempt to engage, in any act, practice or course of business, which operates or would operate as a fraud or deceit upon any person; or,~~

~~(4)~~ Deliver or cause to be delivered, or attempt to deliver or cause to be delivered, for transmission through the mails or interstate commerce, by any means of communication whatsoever, a false or misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate. Notwithstanding the foregoing, no violation of this section shall exist where the person mistakenly transmits, in good faith, false or misleading information to a price reporting service.

(b) Nothing in this section shall be construed to require any person to disclose to another person 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 to the other person in or in connection with the transaction not misleading in any material respect.

(c) Nothing in this section shall affect, or be construed to affect, the applicability of Commodity Exchange Act section 9(a)(2).

(d) "Reckless" or "recklessly", as included in this § 180.1, shall mean a person's knowing undertaking of actions which will lead to a predictable and adverse effect on the fair and competitive functioning of Commission jurisdictional markets such that the integrity of such markets will be impaired, obstructed or defeated.

~~§ 180.2 Other manipulation.~~

~~It shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity.~~