January 3, 2011

**SUBMITTED ELECTRONICALLY**

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

Re: Requests for Comments on the Advance Notice of Proposed Rulemaking Regarding Anti-disruptive Practices Authority, RIN Number 3038-AD26

Dear Mr. Stawick:

The American Petroleum Institute ("API") respectfully submits these comments in response to the advanced notice of proposed rulemaking ("Notice") issued by the Commodity Futures Trading Commission concerning its anti-disruptive practices authority in Section 747 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1]

API is a national trade association representing approximately 400 member companies involved in all aspects of the oil and natural gas industry. API's members transact in physical and financial, exchange-traded, and over the counter markets primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail consumers. Associated with the hedging of physical exposures, API members enter into swap transactions to offset credit risks and to facilitate physical transactions. Because API members rely on the orderly functioning of the markets under the Commission's jurisdiction, we appreciate the opportunity to comment on this Notice.

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[1] *Antidisruptive Practices Authority Contained in Section the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 75 Fed. Reg. 67,301 (Nov. 2, 2010). These comments refer to Section 747 of Dodd-Frank, which amends Section 4c(a) of the Commodity Exchange Act.

## I. Introduction

API supports the Commission's commitment to preventing certain practices that disrupt fair and equitable trading. At the same time, API believes that any proposed rule must provide clear and specific guidance in order to serve that underlying purpose. A rule that establishes vague, overbroad or inconsistent standards will harm markets and their participants by deterring or hindering legitimate business activity or otherwise imposing undue regulatory, legal and financial burdens on participants, including API's members.

Before issuing a proposed rule to prohibit abusive trading practices in the futures and derivatives markets, the Commission should provide clear and straightforward guidance to market participants as to what constitutes prohibited conduct. Specifically, API urges the Commission to consider the following recommendations:

- The Commission should provide specific guidance regarding the scope of the trading practices listed in Section 747.

- The Commission should adopt certain minimum standards. Specifically, API believes that the Commission should clarify that liability under the rule attaches only when: (1) the party had the specific intent to engage in particular disruptive practices; and (2) the trading pattern or practice is not supported by a legitimate business rationale.

- The Commission should clarify that "extreme recklessness" is required for counterparty liability.

- The Commission should first determine whether regulated exchanges have failed their duties before determining that additional regulations are "reasonably necessary."

We also provide answers to specific questions raised in the Notice that establish a number of ways the Commission can identify clear principles and distinguish legitimate business practices from market distorting conduct.

## II. Any proposed rule should provide specific guidance regarding the scope of the trading practices listed in Section 747

### A. The CEA delegates to the Commission the responsibility to provide specific guidance so that the narrowly defined prohibitions may be applied precisely to violative activity

API fully supports the statutory goal of identifying and prohibiting practices that disrupt fair and equitable trading. API believes, however, that given the comprehensive

enforcement and regulatory scheme under the Commodity Exchange Act ("CEA"), and the potential for unintended consequences, the Commission should define the scope of those practices identified in Section 747. In the absence of specific guidance, market participants are likely to reduce the number of legitimate transactions in order to minimize legal risk, which in turn would impair the price discovery function of the commodities markets.

Section 4c of the CEA gives the Commission authority over "Prohibited Transactions." In the context of the wide range of the CEA's enforcement powers, the prohibited transactions in Section 4c can be thought of as those specific transactions that always, or almost always, cause harm and that lack a beneficial, economic purpose.[2] For example, Section 4c(a) prohibits wash sales, which involve the execution of simultaneous offsetting orders where the orders insulate the trader from market risk.[3] The wash sale prohibition is intended to prevent the execution of orders that do not involve beneficial executions, in light of the possibility that such activity, if widespread, would undermine the competitive auction process that is necessary for price discovery.[4] Similarly, the CEA prohibits pre-arranged sales, or transactions in which the parties privately arrange the execution or pricing so as to insulate the transaction from the rest of the market.[5] This prohibition is critical to ensure that pricing is determined in an open and competitive bidding environment. Finally, a further prohibition on non-*bona fide* price reporting reinforces the purpose of Section 4c as preventing activity that can have a distorting effect on market integrity.[6] In all three cases, there are rarely, if ever, beneficial justifications for engaging in the prohibited practices.

Section 747 of Dodd-Frank expands Section 4c of the CEA by prohibiting three specific practices which, in Congress's view, are inherently "disruptive of fair and equitable trading." Congress provided to the Commission rulemaking authority in Section 4c(6) to make such rules as are "reasonably necessary" to prohibit the enumerated practices and any others that are disruptive of fair and equitable trading. Given the comprehensive enforcement scheme already in the CEA, API believes that the

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[2] 7 U.S.C. § 6c(a).

[3] *Id.* § 6c(a)(2)(A).

[4] *See In re San Diego Gas & Elec. Co.*, No. 10-08, Comm. Fut. L. Rep. ¶ 31549, 2010 WL 1638992, at *2 (CFTC Apr. 22, 2010) ("Wash sales are 'grave' violations, even in the absence of customer harm or appreciable market effect, because 'they undermine confidence in the market mechanism that underlies price discovery.'") (citations omitted).

[5] 7 U.S.C. § 6c(a)(2)(A).

[6] *Id.* § 6c(a)(2)(B).

Commission must use its rulemaking authority to provide guidance as to how these prohibited practices fit within the enforcement scheme. Such guidance is "reasonably necessary" because the failure to provide sufficient clarity to those legitimately transacting in the markets risks traders' withdrawal from the markets, deterring beneficial market activity.

### B. Specific guidance is necessary to prevent the chilling of beneficial market activity

API acknowledges that Section 747 does not require the Commission to demonstrate that the listed practices result in an artificial market price. Congress enacted Section 747 to address certain trading practices which, even if not driven by a desire to create an artificial price, may nevertheless impact markets to the detriment of market integrity. But even in the absence of an artificial price requirement, API urges the Commission to adopt a proposed rule that allows market participants to distinguish between improper conduct and legitimate business activity.

API believes the Commission should issue guidance delineating and clarifying the boundaries of the trading practices prohibited and permitted by Section 747. The risk of formulating rules that allow for a case-by-case analysis is that such rules tend to be stated in broad generalities, creating substantial legal uncertainty for market participants and discouraging legitimate transactions. Certain questions posed by the Notice highlight that risk, as they ask for comments on the application of Section 747 regulations on conduct that often has legitimate business purposes that enhance market efficiency. For example, the Commission has asked whether it should "specify an additional disruptive trading practice concerning the disorderly execution of particularly large orders during periods other than the closing period."[7] Likewise, the Commission requested input on whether the statute should "apply to 'buying the board' in an illiquid market."[8] Both of these practices are not *per se* disruptive and have beneficial, legitimate justifications.

The following examples highlight the risk that the statutory language, without specific Commission guidance, would prohibit beneficial market activity:

- Example 1: An oil company provides instruction to its floor broker to purchase crude oil for $90. At the time the floor broker executes the transaction, crude oil is trading at $89.90 on the side-by-side electronic trading platform, Globex. Has the oil trader or the floor broker violated an offer by purchasing the oil at $90

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[7] Notice, 75 Fed. Reg. at 67,302.

[8] *Id.*

when it was available on a different trading platform for $89.90? Is the trader liable even if he/she had no knowledge of the Globex price?

- Example 2: A refinery has an unexpected outage and must procure additional RBOB (reformulated gasoline blendstock for oxygen blending) to satisfy its contractual obligations. The trading desk is not notified until late in the trading day and is faced with a need to transact many times more than its usual number of contracts in a rising market. The trader expects the prices to continue to rise and desires to minimize costs by transacting as soon as possible, but first must obtain the necessary internal approvals to post a large bid. Consequently, the trader posts an unusually large bid for RBOB with 10 seconds left in the closing period. Has the trader recklessly disrupted the orderly closing period?

- Example 3: The same refinery the next day determines that it has overprocured the RBOB it needs and intends to sell back half of the large quantity it purchased at the close. Prices have come down since yesterday's close so the trader is likely to take a loss on the position. To minimize potential costs, the trader posts the entire large quantity for sale at a price that is the same as the last transacted price in the market. The trader's strategy is to post the offer for no longer than a few seconds, and then to cancel the offer and re-post at a smaller quantity or a lower price if no one hits the offer so as not to let the fast moving market cost him more money while he has a large quantity to unload. Even though he is willing to transact at the offered price, has he "spoofed" the market because his strategy involves an intent to cancel if the order is not sold quickly?

An ill-defined rule will not only harm market participants, but will also impede the Commission's enforcement efforts. The history of Section 4c(a) since its enactment shows that courts and the Commission have arrived at differing and contradicting definitions of prohibited practices, which led to the dismissals of enforcement actions. In one case, *United States v. La Mantia*, a federal court held that the term "fictitious sale" in Section 4c of the CEA was too vague to sustain a criminal charge for its violation.[9] The court noted that the term "fictitious" sale was not defined in the CEA, that there had been no judicial construction of the term, and that treatises on commodity trading did not use the term.[10] In another case, *Stoller v. CFTC*, the Commission encountered difficulties in determining the precise definition of "wash sale" under Section 4c. The Second Circuit dismissed an enforcement action in which a trader

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[9] *United States v. La Mantia*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,667 (N.D. Ill. Aug. 9, 1978).

[10] *Id.*

had made simultaneous purchases and sales of transactions because the Commission had taken conflicting positions on what constituted a wash trade.[11] These cases highlight the kinds of difficulties that would inevitably arise if the Commission were to attempt to enforce a vague, ill-defined rule.

For similar reasons, courts have carefully restricted the scope of per se rules of illegality under the antitrust laws. The Supreme Court has determined that certain limited categories of conduct, such as agreements to fix prices or divide markets, should be subject to a per se rule of illegality under the Sherman Act. For those limited scenarios, the marginal utility of further analysis is outweighed by the savings in judicial economy and the avoidance of possible errors.[12] But despite the clear judicial efficiency advantages provided by a per se rule, the Court has restricted its use because of the significant risk of over-deterring pro-competitive conduct. The Court's recent shift toward a more flexible rule of reason analysis for resale price maintenance agreements was largely based on the inability of per se rules to distinguish restrictive from efficiency-enhancing arrangements.[13]

### C. Any proposed rule should adopt certain minimum standards

To avoid the undesirable scenarios described above, API believes that any proposed rule should offer guidance in the form of certain minimum standards. Specifically, any rule should require the Commission to show that: (1) the party had the specific intent to engage in particular disruptive practices; and (2) the trading pattern or practice is not supported by a legitimate business rationale.

#### *1. Specific intent to engage in market-disrupting practices*

API supports Congress's decision to make scienter a requirement to the prohibition in Subsection (B) against disorderly trading during the closing period. API is concerned, however, that Section 747 leaves open the possibility that parties may be held liable for trading practices that fall short of intentional wrongdoing. The possibility that inadvertent or negligent acts could be actionable would significantly alter trading

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[11] 834 F.2d 762 (2d Cir. 1987).

[12] *See Northern Pac. R.R. Co. v. United States*, 356 U.S. 1, 5 (1958) ("[T] here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.").

[13] *See Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 884-86 (2007).

activity, potentially reducing the number of otherwise legitimate commodities transactions in order to mitigate perceived litigation risk.

To avoid that result, any rule under Section 747 should clarify that liability requires a party to act with the specific intent to violate bids or offers or to engage in "spoofing." A specific intent to avoid arms-length *bona fide* trading distinguishes market-disrupting activity from legitimate conduct that produces the same positional and financial outcome. As the examples above demonstrate, some legitimate business activity could be considered violating bids or offers or spoofing under broad language of Section 747. But the goal of Section 747 should be to address situations in which parties actively seek to engage in market-disrupting conduct, not where parties inadvertently violate a bid or offer.

Those considerations are precisely why the Commission has required specific intent for certain trading practices similar to those listed in Section 747. Under Section 4c(a)(A), which prohibits wash sales, accommodation sales, and fictitious sales, the Commission "must do more than prove the existence of trading that is suspicious in terms of matching various aspects of some type of fictitious sales. It must also satisfy a scienter requirement in the sense that a specific intent, an intent to avoid the open market and its inherent risks, distinguishes all types of fictitious trading by definition."[14] Even though a specific intent requirement could raise the bar for identifying disruptive behavior, the Commission nevertheless concluded that the risk of chilling beneficial market activity outweighed the benefits:

> [T]he lines we draw in the trade practice area could easily chill legitimate economic behavior that supports the risk shifting and price discovery function of the markets we seek to protect. Thus, our desire to identify and sanction traders who knowingly participate in illegal trade practices must be balanced by appropriate concern for the effect our linedrawing may have on legitimate trading activity. [15]

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[14] *In re Gorski*, No. 93-5, Comm. Fut. L. Rep. ¶ 27,742, 1999 WL 639178, at *3 n.26 & 36 (CFTC Aug. 23, 1999) (citing *In re Rousso*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,133, at 45,308 (CFTC Aug. 20, 1997); *In re Buckwalter*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,995, at 37,685 (CFTC Jan. 25, 1991).

[15] *In re Three Eight Corp.*, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,749, at 40,444 (CFTC Jun. 16, 1993) (citing *In re Buckwalter*, [1990–1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,995, at 37,684 (CFTC Jan. 25, 1991)).

Without a specific intent standard, market participants would be required to guard against the possibility that the Commission (or courts) might base liability on negligent conduct. This could cause firms to adopt compliance programs that severely limit the speed, volume, or nature of market activity for fear that mere mistakes would create a basis for liability. Restricting market information will make the markets less efficient as price discovery venues.

*2. A safe harbor for conduct with legitimate business rationales*

Regardless of whether the Commission adopts a specific intent requirement, the Commission should provide a safe harbor for conduct that is supported by a legitimate, business rationale. As noted earlier in these comments, broad and ill-defined language of Section 747, without specific guidance from the Commission, could be interpreted to cover beneficial market activity that has no potential to disrupt the integrity of the commodities markets. For example, market participants may have unusual obligations or needs that require an attempt to fill a large order, or a large purchase order may be justified by emergency situations or other unusual market conditions in a rapidly changing market. Similarly, individuals often cancel an order and then re-post at a lower price to ensure that the order is filled. These types of legitimate activities are central to the price discovery function of the commodities markets, and should not be considered disruptive to fair and equitable trading in any circumstance.

To prevent over-deterrence, and the associated harms to market efficiency, the Commission should clarify that there is no liability if a trading pattern or practice is supported by a legitimate business rationale. "[A] clear line between lawful and unlawful activity is required in order to ensure that innocent trading activity not be regarded with the advantage of hindsight as unlawful manipulation."[16] If the Commission does not exempt beneficial conduct with a bright-line rule, the law that forbids disruptive or unfair trading could discourage the very activity that underlies the integrity of the markets they seek to protect.

Moreover, any conduct that may have a legitimate business rationale but also operates as a fraud on the market can be pursued as a violation of the new Section 6(c) provision. Section 6(c) of the CEA, as amended by Section 753 of Dodd-Frank, authorizes the Commission to implement rules prohibiting intentionally deceptive or fraudulent statements or acts designed to distort the commodities markets.[17] Thus,

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[16] *In re Ind. Farm Bureau Coop. Ass'n, Inc. & Johnston*, No. 75-14, 1982 WL 30249, at *6 (CFTC Dec. 17, 1982).

[17] Commodity Futures Trading Commission, *Prohibition of Market Manipulation* (*Notice of Proposed Rulemaking)* 75 Fed. Reg. 67,657 (Nov. 3, 2010).

novel or ingenious fraud schemes can be addressed in the context of these broad prohibitions against fraudulent or deceptive behavior.

## III. Any rule should clarify that extreme recklessness is required for counterparty liability

API has significant concerns regarding the scienter standard under Subsection 4c(a)(7), which holds market participants liable for "acting in reckless disregard of" a counterparty's deceptive or fraudulent conduct on any third party. In a market environment where traders bring their own proprietary information, parties are not typically privy to their counterparties' information and motivations.[18] The possibility that market participants are held liable for "reckless disregard" of the motivations of others will cause them to question otherwise legitimate commodities transactions in order to mitigate perceived litigation risk, thereby reducing market efficiency.

The Commission has previously required a high level of culpability for aiding and abetting liability under Section 13(a) of the CEA, irrespective of the level of proof required to establish the primary violation.[19] To be held liable for aiding and abetting under Section 13(a), "one must [1] knowingly associate himself with an unlawful venture, [2] participate in it as something that he wishes to bring about and [3] seek by his actions to make it succeed."[20] According to the Commission, the requirement that an individual share the intent of the principal is "[b]y far the most important element of aiding and abetting."[21] It ensures that remedial sanctions will not be imposed against a secondary respondent who intentionally assists a primary wrongdoer, but lacks knowledge of the unlawful conduct.

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[18] Notice, 75 Fed. Reg. 67,303; Commodity Futures Trading Commission, *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information* 53-54 (Sept. 1984) ("By the nature of their businesses, many hedgers are privy to nonpublic information that may prove to be material in futures markets. … Such access to superior or more timely information is inherent in the markets, and futures market participants voluntarily accept this situation if they choose to trade.").

[19] 7 U.S.C. § 13c(a).

[20] *See, e.g., In re Richardson Sec., Inc.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,145, at 24,646 & n.14 (CFTC Jan. 27, 1981). *See also In re Earl K. Riley Co.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,854, at 27,583-84 & n.4 (CFTC Nov. 24, 1981) (finding that Congress had intended that Section 13(a) liability "require proof of unlawful intent" and, on that basis, holding that reckless conduct "may not form the basis of aiding and abetting liability under § 13(a) of the Commodity Exchange Act").

[21] *Id.* ¶ 24,643.

API acknowledges that the statute expressly holds market participants liable for "reckless" conduct. In light of that statutory language, API requests that the Commission clarify that liability requires a showing of "extreme recklessness," which means a showing that "suspicious events creating reasons for doubt that should have alerted [the respondent] to the improper conduct of the primary violator" or of "danger … so obvious that the actor should have been aware."[22] Given the need for clear compliance programs that establish brightline rules for traders, anything less than an "extreme recklessness" standard is likely to cause market participants to adopt rules that discourage trading at favorable market conditions.

## IV. Answers to specific questions raised in the Notice

### A. Demonstrating intentional or reckless disregard for the orderly execution of transactions

#### *1. Any proposed rule should limit liability to conduct that is intended to and has the effect of derailing the matching of best bids and offers (questions 3 and 4)*

The closing period is critical to commodity markets because it is used as a reference for many physical market transactions. Oil companies and other end-users enter into long-term supply contracts in which the price is determined by the daily closing price. Those companies may choose to trade in the closing period in order to minimize the risk that the transaction price will differ from the contract price. Thus, active trading during the closing period is critical to the basic risk-shifting purpose of the futures market. It allows market participants to take the most efficient and accurate position in the futures market in order to hedge a price risk incident to an undisclosed past or future cash market transaction.

In light of the critical function of the closing period for price discovery, and the significant costs of regulatory error, the Commission should define "disorderly trading" as trading practices that specifically intended to, and that have the effect of, derailing the matching of best bids and offers during the closing period. The Commission should also clarify that market activity in response to price signals, not motivated by an intent to upset the matching of bids and offers, should not be actionable.

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[22] *Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004) (quoting Graham v. SEC, 222 F.3d 994, 1006 (D.C. Cir. 2000); SEC v. Steadman, 967 F.2d 636, 641-42 (D.C. Cir. 1992)). *See also Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir.) , *cert. denied,* 434 U.S. 875 (1977)..

Market activity during the closing period is often characterized by chaotic and rapid-fire decision-making, which makes careful determinations about "orderly" versus "disorderly" trading extraordinarily difficult. In an investigation, the Commission will be second-guessing decisions that occurred in real time, before information was fully circulated and analyzed. *Ex post*, the Commission will have access to complete information, and the time to digest it, in ways that simply were not possible when the decisions were made. The Commission may receive complaints from "aggrieved" parties who have an incentive to gain advantages in future dealings. All of these problems are present even under normal conditions, but they are especially likely to occur during the closing period.

*2. Any proposed rule should require specific intent or, at a minimum, "extreme" recklessness*

API supports Congress's requirement that scienter should be a prerequisite to liability for disorderly trading during the closing period. API is concerned, however, that an undefined "recklessness" standard could increase the costs of complying with any rule and deter market participants from engaging in transactions that provide critical liquidity to the commodities markets. The Commission should therefore clarify that "disorderly trading" requires extreme recklessness, or a showing that "suspicious events creating reasons for doubt that should have alerted [the respondent] to the improper conduct of the primary violator" or of "danger … so obvious that the actor should have been aware."[23]

The possibility that "ordinary recklessness" during the closing period could be actionable could have wide-ranging adverse effects on market efficiency. Combining the uncertainty of what crosses the line into "recklessness" with a vague prohibition on primary conduct would leave traders with too much uncertainty about what is or is not allowed, potentially reducing the number of otherwise beneficial commodities transactions in order to mitigate perceived litigation and legal risk. In dynamic, fast-moving markets, the dividing line between transactions that are reckless (reflecting an extreme departure from ordinary care) and those that are negligent (departing somewhat from ordinary care) can easily be debated, and different fact-finders may reach different results even on identical facts. Further, the costs of a recklessness standard are increased by the tendency of courts during litigation to interpret and apply the recklessness standard in different ways. In the securities context, the Courts of Appeals have adopted a number of different formulations as to precisely what constitutes recklessness. A Commission rule that adopts a "recklessness" standard without clarification would not prevent different circuits, guided by their respective Rule

[23] *See* supra note 22.

10b-5 precedents, from applying different tests to establish scienter for the purposes of the Commission's anti-disruptive trading practices rule.

The failure to limit the scienter requirement to extreme recklessness could cause traders to shy away from participating during this critical period of liquidity. If that happens, the rule would damage the efficiency of the markets and undermine the critical role of the closing period for price discovery.

*3. Any proposed rule should limit liability to consummated transactions during the closing period (questions 5 and 6)*

In addition to limiting liability to conduct specifically intended to derail the matching of best bids and offers, API also believes that the adverse consequences of extending liability to consummated transactions outside the closing period far outweigh the limited benefits.

- Transactions outside the closing period. Trading practices or conduct outside of the closing period are not relevant to determine whether conduct inside the closing period is deemed "orderly." The closing period is used as a reference for pricing because it provides the most meaningful reflection of the market price for short- and long-term supply contracts. Trading outside of the closing period can tend to be far less active, making prices less relevant to the closing price.

- Non-consummated transactions. The benefits that would result from extending any rule beyond consummated transactions are outweighed by the potential harms. Most contract settlements reference only consummated transactions. Given the hectic trading patterns of the closing period, a rule making non-consummated transaction activity actionable would sweep too broadly when such transactions almost never figure into the calculation of a settlement price.

While the benefits are small, the costs are significant. Corporate compliance programs typically seek to establish clear rules for employees who lack specialized legal training. A rule that covers any conduct that could have an indirect effect on the closing period could cause firms to adopt compliance programs that severely limit the amount of trading for fear that any "distortion" would create a basis for liability. Likewise a rule that applies to order activity could reduce the range and volume of bids and offers by market participants, which in turn further reduces legitimate market activity and impairs the price discovery function of the commodities markets.

To the extent the Commission is concerned about manipulative order activities or conduct outside the closing period, any pernicious conduct by market participants would be actionable under the existing enforcement authority under the CEA and the enhanced authority under Dodd-Frank. Section 6(c) and the Commission's proposed

implementing rule prohibit any activity intended to defraud or deceive a market participant, while Section 9(a)(2) prohibits traders from intentionally engaging in manipulative conduct. Taken together, these provisions provide sufficient authority for the Commission to police disruptive order activity or trading behavior outside of the closing period.

*4. Any proposed rule should not impose obligations on executing brokers (question 7)*

API believes that executing brokers should not be forced to police the market, to monitor conduct, and to make determinations about disruptive conduct. In today's markets, brokers are responsible for implementing customers' orders in real time, making best efforts to match bids and offers, without the necessity for input from counsel or management. In most cases, brokers do not have sufficient time or information about the purpose of their customers' trades to be in a position to monitor effectively for disruptive orders. A rule that requires brokers to monitor an ill-defined set of reckless trading practices could lead them to be less willing to assist matching buyers and sellers, chilling beneficial transactions and denying liquidity to the commodity markets. The use of brokers is essential in certain cash and swap markets to bring parties together and facilitate efficient transactions. Thus, costs will increase for all market participants, taxing the efficiency of the market without significantly benefiting the market or consumers to justify the costs.

**B. Bidding or offering with the intent to cancel the bid or offer before execution**

*1. Any proposed rule should create a safe harbor for any bid or offer that has a legitimate business purpose (questions 8, 9, and 11)*

As explained earlier in these comments, API believes that Section 747's prohibition on "spoofing," or submitting bids or offers with the specific intent to cancel the bid or offer before execution, could be interpreted as prohibiting a wide range of legitimate transactions. If the Commission is unwilling to adopt a safe harbor for all practices that have a legitimate business purpose, the Commission should, at a minimum, clarify that liability under this Subsection is limited to bids or offers that have no beneficial purpose. In doing so, the Commission should list specific prohibitions and legitimate practices so that any rule may be applied precisely and promptly to violative activity. Leaving the statutory provision in place without identifying legitimate or prohibited behavior could lead to false positives and chill legitimate trading.

The Commission acknowledges in its Notice that "legitimate trading activity" includes a scenario "where an individual enters an order larger than necessary with the intention to cancel part of the order to ensure that his or her order is filled."[24] Market participants also place large trades in certain illiquid commodities markets in order to gather information about market participants' willingness to accept particular terms. Far from "distorting," such activity sends a signal to the market of a party's intent to transact in a particular way. To prevent over-deterrence, and the associated harms to market efficiency, the Commission should exempt those beneficial practices.

Moreover, the Commission should not "separately specify and prohibit" certain additional practices, including "[s]ubmitting or cancelling bids or offers to overload the quotation system of a registered entity," "to cause a material price movement," or "to create an appearance of market depth that is false."[25] To the extent that these practices are fraud-based manipulation, the CEA already prohibits these practices in Section 6(c) and 9(a)(2) of the CEA. Subpart (b) of question nine in the Notice describes conduct which is intended to manipulate market prices, while subparts (a) and (c) describe practices which are intended to defraud or deceive market participants with a manipulative effect. Extending the rule to these additional practices would impair the efficiency of the market without significantly benefiting the market or consumers to justify the costs.

*2. Any proposed rule should exempt liability for partial fills of orders (question 10)*

The Commission has requested comment on whether a "partial fill of an order … necessarily exempts that activity from being defined as 'spoofing.'"[26] The answer is yes. A partial fill indicates that two market participants were willing to transact on those terms. To the extent "spoofing" is a market concern because it sends false signals about whether and at what prices parties are willing to transact, the consummation of the transaction negates that concern. In other words, a market signal is valid if parties in fact agree to transact at a particular price.

### C. Violating bids or offers (question 2)

As explained earlier in these comments, API is concerned that the statute does not expressly make specific intent a requirement to that provision. The possibility that

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[24] Notice, 75 Fed. Reg. at 67,302.

[25] *Id.*

[26] Notice, 75 Fed. Reg. at 67,302.

negligent conduct could be actionable could significantly alter trading activity, potentially reducing the number of otherwise legitimate commodities transactions in order to mitigate perceived litigation risk. The Commission should clarify that an individual may not be held liable unless he or she specifically intends to violate bids or offers.

For example, individuals are often operating in a crowded environment with a high volume of traders attempting to trade simultaneously. On some occasions, it is possible that a trader cannot observe the full range of offers and transacts with only the individuals he can reach. Unless specific intent is required, the individual—who engaged in no manipulative or distorting act—could be subject to an enforcement action.

Finally, the Commission should clarify that simply "buying the board" is not a violation of the statutory provision because there could be legitimate, beneficial reasons to do so. A trader may have unusual obligations or needs that require an attempt to fill a large order, or a large purchase order may be needed in emergency situations or other unusual market conditions in a rapidly changing market. Holding traders liable for engaging in beneficial conduct will increase costs for all market participants.

### D. The CEA's enforcement and regulatory regime makes the broadening of any proposed rule unnecessary (questions 13 and 14)

API believes that identifying practices beyond the three practices identified in Section 747 would, at least at this stage in the development of the law, run counter to the comprehensive regulatory scheme under the CEA and could impair the efficient operation of the energy markets without providing the benefits intended by the Commission. Section 747 of Dodd-Frank amends Section 4c of the CEA, which in turn prohibits those practices that are inherently disruptive of fair and equitable trading. A rule targeting a broader set of trading practices would blur the line between beneficial trading and market-distorting conduct, which in turn would deter market participants from engaging in beneficial transactions that help maintain market liquidity. Given the existing enforcement authority available to the Commission to seek out practices that are intended to manipulate the commodities markets as well as the new authority Congress granted to the Commission under Section 753 of Dodd-Frank, it is vital that any anti-disruptive trading practices rule provide guidance but be limited so as to minimize duplication and inconsistency with other prohibitions in the CEA.

API acknowledges that there are certain trading practices that may not be intentionally manipulative or fraudulent, but nevertheless may have a market-distorting effect. The principles-based regulatory regime embodied in the CEA requires that those trading practices will be policed internally by self-regulated exchanges. Historically, the Commission has viewed self-regulated exchanges as the front line defense against

abusive trading practices that harm the efficient operation of the commodities markets. Prior to the enactment of Dodd-Frank, Section 5(d) of the CEA required futures exchanges to meet certain "core principles" to obtain and maintain a designation as a contract market ("DCM"). One of those core principles required the exchange to "establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants."[27] Section 735 of Dodd-Frank broadened the scope of that provision by: (1) extending it to "any party," not just those acting as an agent, and (2) requiring regulated exchanges "to promote fair and equitable trading on the contract market."[28]

Under those provisions, regulated exchanges are tasked with issuing extensive rules prohibiting abusive practices and enforcing them with civil penalties, sanctions, and debarment. For example, the Chicago Mercantile Exchange ("CME") has promulgated broad, flexible rules which make it an offense to: (1) "engage in conduct or proceedings inconsistent with just and equitable principles of trade," (2) "create or report a false or fictitious trade," (3) place "a bid or offer which tends to confuse the other trades," or (4) place "a trade through the existing bid or offer."[29] The CEA also gives regulated exchanges the responsibility to monitor market participants' compliance with those rules.[30]

API understands that the Commission has the authority under Section 747 to go beyond the three enumerated anti-disruptive practices and "promulgate such rules and regulations as … reasonably necessary to prohibit the trading practices … and any other trading practice that is disruptive of fair and equitable trading."[31] Given the principles-based foundation of the CEA, however, the Commission should first determine that regulated exchanges have failed their duties before promulgating additional regulations that are "reasonably necessary."[32] As its regulatory experience in this area grows, the

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[27] 7 U.S.C. § 7(d); *see also* 17 C.F.R. Part 38, App. B.

[28] 7 U.S.C. § 7(d)(12).

[29] CBOT Rulebook, Rule 432, 514 *available at* http://www.comex.com/rulebook/CME/.

[30] 7 U.S.C. § 7(d)(4) (according self-regulated exchanges the responsibility to monitor for abusive trading practices).

[31] Notice, 75 Fed. Reg. at 67,302.

[32] *Cf. Industrial Union Dep't, AFL-CIO v. API*, 448 U.S. 607, 642 (1980) ("By empowering the Secretary [of Labor] to promulgate standards that are 'reasonably necessary or appropriate to provide safe or healthful employment and places of employment,' the [Occupational Safety and Health] Act implies that, before promulgating any standard, the Secretary must make a finding that the workplaces in question are not safe. But "safe" is not the equivalent of 'risk-free.' … Therefore, before he can promulgate *any*

(continued…)

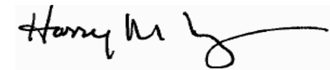
Commission may promulgate new regulations if further experience demonstrates that they are needed. This preserves the Commission's need for flexibility while providing sufficient protection to those transacting in the markets legitimately.

## V. Conclusion

For the reasons described in its comments, API is concerned that a broad, ill-defined rule could impair the efficient operation of the commodities markets without providing benefits intended by Congress and the Commission. The adverse consequences could include higher costs, reduced liquidity, and greater compliance risks and costs, all of which would encourage market participants to move trading to offshore exchanges. None of these outcomes is beneficial to the U.S. economy, markets, or consumers.

API appreciates the opportunity to provide these comments. We would be pleased to provide additional information regarding our views regarding the proposed rule, and would welcome the opportunity to work with the Commission.

Sincerely yours,



Harry Ng

*Vice President, General Counsel & Corporate Secretary, American Petroleum Institute*

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner
Robert Pease, Counsel to the Director of Enforcement
Mark D. Higgins, Counsel to the Director of Enforcement

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permanent health or safety standard, the Secretary is required to make a threshold finding that a place of employment is unsafe-in the sense that significant risks are present and can be eliminated or lessened by a change in practices.").