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COMMENT

February 16, 2011

Via Hand Delivery

David A. Stawick, Secretary
Commodity Futures Trading Commission
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:

This letter is submitted on behalf of the Derivatives and Futures Law Committee (the "Committee") of the Business Law Section of the American Bar Association (the "ABA") in response to the Commodity Futures Trading Commission's (the "Commission") request for comment in its Notice of Proposed Rulemaking on the Prohibition of Market Manipulation (the "Proposing Release").[1]

The views expressed herein have not been approved by the House of Delegates or Board of Governors of the ABA and should not be construed as representing policy of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

The Committee is comprised of lawyers who work extensively in the area of derivatives law, including private practitioners, members of the law departments of businesses, government and self-regulatory organizations, and law professors. Its membership draws from all constituencies of the derivatives industry, including, among others, commercial end users, clearinghouses and exchanges, banks and other financial organizations, commodity trading advisors, investment advisers, futures commission merchants, broker-dealers, hedge funds, and energy-industry and other companies involved with the purchase, sale and processing of many commodities. The Committee's work concerns the legal and policy issues relating to derivatives, including exchange-traded futures and options contracts and over-the-counter ("OTC")

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1 Prohibition of Market Manipulation, 75 Fed. Reg. 67,657 (Nov. 3, 2010). We apologize that our letter is being filed subsequent to the formal deadline for public comments. Unfortunately, our collective process for preparation and review of this letter could not be completed by the deadline, but we submit our comment with the hope that it will nonetheless aid and inform the Commission's deliberations in this rulemaking.

transactions. The Committee focuses on the regulation of these markets and their participants (*e.g.*, exchanges, clearing organizations, swap dealers, commercial market users, speculators, intermediaries, and investment managers) by the Commission, the Securities and Exchange Commission ("SEC"), federal energy and banking regulators, international regulators, self-regulatory organizations, and state authorities.[2]

The Committee thanks the Commission for this opportunity to provide comments on its proposed rule to implement its new and expanded anti-manipulation authority pursuant to Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). We support Congress' and the Commission's goal of preserving the integrity of the futures and derivatives markets.

I. Overview

The Commission is uniquely positioned to provide much needed and timely clarity on an uncertain and confused body of law surrounding manipulation. In acting to prevent manipulative practices in the futures and derivatives markets, we urge the Commission to provide clear and straightforward guidance to market participants on the differences between permissible and prohibited conduct. This is particularly important because the Commission is the expert agency, and, insofar as Congress has provided for a private right of action for manipulation, affected market participants and the courts can benefit from its guidance. The Committee believes that certain overarching legal principles embodied in the statute and Congress's legislative intent should guide the Commission's adoption of any anti-manipulation rules. Those principles are discussed in detail below. At the same time, the Committee recognizes that rulemaking under Section 753 of the Dodd-Frank Act is not an easy exercise.

II. Section 753 of the Dodd-Frank Act Establishes a New Statutory Structure for Civil Anti-Manipulation Prohibitions and Enforcement

Section 753 of the Dodd-Frank Act affects the Commission's civil anti-manipulation enforcement authority in a number of ways:

1. New Sections 6(c)(1) and 6(c)(3) provide express substantive civil prohibitions against manipulation and expand the Commission's anti-manipulation authority to cover swaps, as defined in the Commodity Exchange Act ("CEA").

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[2] This letter was prepared under the direction of the Committee's Chair, Charles R. Mills, and Vice Chair, Kenneth M. Raisler, with contributions from a number of other Committee members as noted below. However, Susan C. Ervin, also a Vice Chair of the Committee, was not involved with the preparation and review of this letter due to her position with the SEC.

2. Sections 6(c)(1) and 6(c)(3) bifurcate the CEA's civil anti-manipulation prohibitions into two separate types. Section 6(c)(1) establishes Commission rulemaking authority to prohibit fraud-based manipulations and makes violation of such rules a violation of Section 6(c)(1). Section 6(c)(3) provides a general civil prohibition against any "Other Manipulation," but does not require rulemaking with respect to such prohibition.

3. The Supreme Court has extensively and authoritatively construed the words "to use or employ any manipulative or deceptive device or contrivance" as they appear in Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), as amended, 15 U.S.C. § 78j, as "proscrib[ing] knowing or intentional conduct."[3] The United States Courts of Appeals have applied a standard of extreme recklessness for the *mens rea* element for deceit for Section 10(b) violations.[4] Under traditional principles of statutory construction, these interpretations of Section 10(b) would apply with equal force to the construction of Section 6(c)(1).

Section 6(c)(1), however, also includes a prohibition not found in Section 10(b) – an express prohibition against the adoption of any rule that would 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 to make any statement made to the other person in or in connection with the transaction not misleading in any material respect. The Committee believes that this prohibition reflects the longstanding principle that commodity market participants generally have no independent, affirmative disclosure obligations and, apart from any contractual duties they might otherwise specifically agree to with counterparties, principals, or employers, are entitled to trade on the basis of material, nonpublic information.

4. Section 6(c)(1)(B) expressly provides that nothing in Section 6(c)(1) shall affect, or be construed to affect, the applicability of the criminal proscriptions in Section 9(a)(2).

III. Any Rules Promulgated by the Commission Should Be Tailored to the Markets and Participants to Which They Will Apply

Material differences exist between the dynamics of pricing in the highly regulated exchange-traded futures markets and the many, diverse and idiosyncratic OTC swap and cash commodity markets. The material differences between the markets could result in certain conduct being deemed manipulative in one but not the other. Anti-manipulation standards should take

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

[4] *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). *Accord, e.g., 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, 961-62 (5th Cir. 1981) (*en banc*); *McLean v. Alexander*, 599 F.2d 1190, 1197-98 (3d Cir. 1979); *Mansbach v. Prescott, Ball, & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *Greebel v. FTP Software*, 194 F.3d 185, 198-99 (1st Cir. 1999).

account of those differences. Further, for all markets it is important that a trader be armed with clear standards that allow the trader to know when a course of conduct is likely to be deemed to cause a price move that could later be characterized as "artificial."

Pricing in exchange-traded commodity futures markets generally focuses on the differential between a current cash price and the futures price for the same commodity. The relatively few litigated cases of manipulation of futures prices tend to focus on abnormalities in the differential between the futures and the cash prices.[5] Further, futures are traded in a centralized marketplace that is overseen and regulated by the Commission and the exchange itself. There are many clear, objective, and finely calibrated economic and legal demarcations for transactions and positions in that marketplace. For example, daily price limits regulate how far the futures price for a commodity in a particular contract month may rise or fall in a day. Moreover, the number of contracts traded daily, the number of open contracts, and the pricing of contracts is publicly disseminated daily and often within seconds. Further, large futures traders are required to report their positions daily to the Commission and the exchange. The Commission and exchange surveillance staffs closely monitor large positions and collect nonpublic market information and through "jawboning" they directly notify large traders in "real time" of their liquidation, pricing, delivery and other expectations and concerns.[6] In many situations, these factors combine to give futures traders notice of where legal lines may be drawn regarding their activities in the market.

Traders in OTC markets may not have such precise measures available to them and do not have advance notice of regulators' contemporaneous views on specific positions. Those markets operate simply through private, individually negotiated bilateral contracts with known counterparties. The "market" is not a centralized, legally defined and regulated organization and structure, but, rather, a term that colloquially refers to the collective activities of individual

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[5] *See, e.g., In re Cox*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786, at 34,065 (CFTC 1987) ("In prior manipulation cases, cash market prices for the underlying commodity have often been cited to measure the artificial nature of the futures prices."). The Commission's Proposing Release correctly notes that there also have been instances in which the pricing issues have related purely to futures pricing where a trader offered and executed at wholly non-competitive prices. *In re Diplacido*, 2008 WL 4831204, (CFTC Nov. 5, 2008), *aff'd. DiPlacido v. CFTC,* 2009 WL 3326624 at *3 (2d Cir. 2009) (unpublished summary order); *In re Henner*, 30 Agri. Dec. 1151 (1971).

[6] The Commission's website previously described its "jawboning" with market participants as follows: "The market surveillance process is not conducted exclusively at the CFTC. Surveillance issues are usually handled jointly by the CFTC and the appropriate exchange. Relevant surveillance information is shared and corrective actions are taken, when appropriate. Potential problem situations are jointly monitored and, if necessary, verbal contacts are made with the participants in question. These contacts may be for the purpose of understanding their trading, confirming reported positions, alerting the brokers or traders as to the regulatory concern for the situation, or warning them to trade responsibly. This 'jawboning' activity by the Commission and the exchanges has been effective in resolving most potential problems at an early stage."
http://www.cftc.gov/industryoversight/marketsurveillance/cftcsurveillance.htm (last visited March 2009). *Accord, e.g.*, Oral testimony of CFTC Commissioner Walter L. Lukken before the Committee on Agriculture, U.S. House of Representatives (April 27, 2006).

participants dealing independently, separately, privately and directly with one another. While the Commission's rulemakings implementing the Dodd-Frank provisions for the regulation of swaps will undoubtedly result in a more regulated and structured market for swaps, including greater price and volume transparency and centralized trading for many swaps, the OTC markets will continue to be a substantial part of this market and will not be as highly structured, regulated or overseen as futures markets.

IV. Legal Issues Concerning Section 6(c)(1)

A. General Principles

Any Commission rules under Section 6(c)(1) should give fair notice of what is proscribed, *i.e.*, be reasonably clear and easily understood by market participants. CEA manipulation law has been burdened by some confusing and contradictory rulings and principles that tend to be applied on the basis of after-the-fact economic analysis and market information that was not publicly available or known to the accused at the time of the trading in question. Going forward, markets will benefit from anti-manipulation rules that provide market participants with clear guideposts and standards that can be applied and inform trading decisions when trading is occurring.

The Committee respectfully suggests that such a standard is best met by a rule that expressly targets intentional or extremely reckless deceitful conduct specifically intended to cause artificial prices by corrupting or disabling the integrity of market price-setting processes and mechanisms rather than by a general anti-fraud rule patterned on SEC Rule 10b-5. We therefore respectfully recommend that an anti-manipulation rule under Section 6(c)(1) expressly set forth the essential elements of manipulation to include, at a minimum: an intentional or extremely reckless deception of market participants by a misrepresentation or actionable omission of a material fact that (a) is made with a specific intent to cause artificial market prices, (b) has the ability in fact to cause artificial market prices, and (c) in fact causes artificial prices. Such elements of liability would capture the essential anti-manipulation objectives of the CEA. Congress sought to protect the integrity of competitive markets but not at the expense of discouraging legitimate competition. Accordingly, we believe that the most appropriate way to ensure that a Commission anti-manipulation rule punishes price manipulators in the futures and derivatives markets is to target those persons whose goal it is to profit from creating artificial prices through fraudulent conduct.

B. A Commission Rule Under Section 6(c)(1) Should Require Fraud or Deceit

Even if the Commission were to adopt a rule modeled on SEC Rule 10b-5, the Commission's proposed anti-fraud rule under Section 6(c)(1) should be clearly limited to manipulative conduct that has clear elements of fraud or deception. The Supreme Court has held that deception or fraud is an essential element of a claim under Section 10(b): "Section 10(b) is

aptly described as a catchall provision, but what it catches must be fraud[,]"[7] and that mere unfairness or impermissible overreaching without deception does not violate Section 10(b) or SEC Rule 10b-5 thereunder.[8]

When interpreting similar language under Section 14(e) of the Exchange Act, the Supreme Court in *Schreiber* held that such language requires a fraudulent misrepresentation or nondisclosure (where there is a duty to disclose) for a party to be liable for manipulation.[9] In doing so, the Court explicitly overruled a previous Sixth Circuit holding which had read the 10(b) language too expansively to reach conduct that "resulted in a price which does not reflect the basic forces of supply and demand," a standard that was drawn from futures law.[10] Accordingly, consistent with the Supreme Court's interpretation of the same statutory language, Section 6(c)(1) requires a fraudulent misrepresentation or nondisclosure of a material fact where there is a duty to disclose. Such a material misrepresentation, of course, is not limited to just speech. For example, in the case of a collusive wash sale, a misrepresentation would be communicated through a false transaction.

As noted by the Commission,[11] following the enactment of the Energy Policy Act of 2005 ("EPAct"), the Federal Energy Regulatory Commission ("FERC"), pursuant to its statutory authority that also is modeled on Section 10(b) of the Exchange Act, promulgated anti-manipulation Sections 1c.1 and 1c.2, which are modeled on SEC Rule 10b-5.[12] Those rules, by their terms, are limited to fraud-based manipulations. Unlike the CEA, the EPAct did not confer authority to prosecute non-fraud based manipulations. The Commission's authority with respect to non-fraud manipulations is expressly provided in Section 6(c)(3) of the CEA.

The FERC, however, declared in its adopting release (although not in the rules themselves) that fraud for purposes of its anti-manipulation rules is defined to include "any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market."[13]

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7 *Chiarella v. U.S.*, 445 U.S. 222, 234-35 (1980).

8 *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *see also Ernst & Ernst v. Hochfelder*, 425 U.S. 185.

9 *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 8,12 (1985) (the word "manipulative" in Exchange Act Section 14(e) "requires misrepresentations or nondisclosure. . . . Without misrepresentation or nondisclosure, § 14(e) has not been violated.... Congress used the phrase 'manipulative or deceptive' in § 10(b) as well, and we have interpreted 'manipulative' in that context to require misrepresentation.").

10 In *Mobil*, the Sixth Circuit erroneously looked to another circuit's interpretation of the CEA to interpret the word "manipulative" within the meaning of Section 14(e) of the Williams Act, which, like CEA Section 6(c)(1), also is based on Exchange Act Section 10(b). *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 374 (6th Cir. 1981) (citing *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971)).

11 75 Fed. Reg. at 67658.

12 Prohibition of Energy Market Manipulation, 71 Fed. Reg. 4244, 4246 (Jan. 26, 2006) (codified at 18 C.F.R. pt 1c).

13 *Id.* at 4253.

We do not believe the FERC definition is consistent with interpretations of Exchange Act Section 10(b) as construed by controlling Supreme Court precedent and any commonly known definition of fraud.[14] We therefore do not believe the FERC interpretation serves as appropriate precedent for the Commission in crafting its own anti-manipulation rules.

C. The Commission Should Make Clear That Section 6(c)(1) and Any Rule Thereunder Does Not Embrace Securities Law Theories that are Incongruous with Futures and Derivatives Markets

The Commission should capitalize on its expertise in regulating futures markets to craft a rule which takes into account the fundamental differences between the futures markets on the one hand and the securities markets on the other. Many theories of liability for violation of Securities Exchange Act Section 10(b) and SEC Rule 10b-5 thereunder are inextricably founded on the following factors that distinguish securities and their markets from futures and OTC derivatives markets:

(1) Much of the information material to the pricing of an issuer's security is developed and held internally by the issuer;

(2) Absent special legal requirements, this fact would permit an issuer to manipulate the price of its securities – to create false pricing of its securities – by making fraudulent misrepresentations or selectively disseminating some information and withholding other information to create false or misleading impressions about the value of its securities; and

(3) Retail investors comprise a substantial part of the securities markets but, absent special rules to protect them, would lack resources to access material information as quickly as institutional and professional investors.

As a result of these factors, the federal securities laws, SEC regulations and state securities statutes and regulations, in order to effectuate the public interest in fair and honest pricing of securities, (a) mandate equal access of all market participants to all issuer disclosures of its material information,[15] and, toward that end, (b) impose on public issuers many specialized and

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[14] *See, e.g., Chiarella v. U.S.*, 445 U.S. at 228-30 and 234-35 (discussing the commonly known definition of fraud). Further, terms like "obstructing," "impairing," and "well-functioning" have no legal definition, are vague and subjective, and do not satisfy constitutional due process standards of notice of what conduct is prohibited because lawful, competitive conduct could fall within the vague and subjective concepts of "obstructing," "impairing," and "well-functioning."

[15] *See* SEC Regulation Fair Disclosure, 17 C.F.R. 243.100. Based on this regulatory regime, underlying FOMT is the notion that a security's price itself is a representation about a particular issuer's current financial condition and growth prospects based on the finite body of information required to be publicly disclosed. In *Basic*, the Supreme Court explained the market's role as follows:

extensive affirmative duties to publicly disclose information material to the value of their securities, and (c) prohibit corporate insiders and others that possess and are obligated to protect the confidentiality of material, nonpublic issuer information from trading on the basis of that information before it is publicly disclosed.

The futures and derivatives markets function on a very different premise. Information bearing on the price of a derivative or its underlying commodity is scattered and held by many diverse sources. A great deal of material information is privately held and nonpublic. There is unequal access to material information. The instances where there is an affirmative duty to disclose market information are extremely limited. Generally, there is no prohibition on market participants who are not also government officials from trading on the basis of material, nonpublic information. Finally, the markets are the province of institutions and professionals and have few or no retail investors.

The futures and derivatives markets facilitate price discovery and the assumption and transfer of risk. The Commission recognized this basic economic function in its landmark 1984 study entitled "A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information":

> 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.[16]

The Commission further recognized that there is no expectation that all market participants in the futures and derivatives markets have equal access to material market information:

> Numerous futures market participants may have legitimate access to what some may perceive as superior information. For example, hedgers, who comprise a substantial portion of the markets, also

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> In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor. With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.

Basic, Inc. v. Levinson, 485 U.S. at 244 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (ND Tex 1980)).

[16] 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, 8, 55-56 (Sept. 1984).

> participate in the production, processing, distribution and/or consumption of the cash commodity underlying the futures market. By the nature of their business, many hedgers are privy to nonpublic information that may prove to be material in futures markets. Alternatively, speculators have knowledge of their own futures or cash market positions and some traders may have superior resources with which to purchase or develop research information. Moreover, traders on the floor of an exchange may have advantages of time and place over others. Such access to superior or more timely information is inherent in the markets, and the futures market participants voluntarily accept this situation if they choose to trade.[17]

Consistent with this, the concept of "insider trading" in the futures and derivatives markets has a far more limited scope than in securities laws, and there are no affirmative duties of disclosure or abstention similar to those mandated by securities precedent.[18]

For the foregoing reasons, the Commission should make clear that securities law doctrines such as the prohibition on insider trading and the "fraud-on-the-market" theory ("FOMT") do not apply under its anti-manipulation rule. Congress specifically addressed this in its proviso to Section 6(c)(1), in which it generally prohibited the Commission from requiring market participants to disclose material nonpublic information. For the markets to work as intended, traders must be allowed to profit from the material nonpublic market information they possess. Further, derivatives and commodity prices cannot be presumed to reflect a collective valuation that is based on the same corpus of material information available to all participants. Imposing such principles on the futures and derivatives markets would severely impair the markets' core ability to provide for the hedging of risk and for price discovery.

The FOMT establishes a rebuttable *presumption* in private rights of action under Exchange Act Section 10(b) and SEC Rule 10b-5 that in an efficient market for a security a plaintiff can be held to have relied on a defendant's fraudulent misrepresentation or omission in connection with the purchase or sale of a security – even if the plaintiff was not aware of the misrepresentation or mission – by virtue of the plaintiff's reliance on the fact that a security's price reflects the fraudulent misrepresentation and omission. The FOMT is based on the premise, which does not apply in futures, swaps or cash commodity markets, that, at any point in time, the price of a stock in an efficient market reflects *only* the available public information about a security.[19]

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17 *Id.* at 53-54.

18 *Id.* at 55-56.

19 The Supreme Court explained the FOMT as follows:

> [FOMT is] based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material

Due to the inequality of access to information in derivatives and commodity markets, it cannot be presumed even in an efficient market that any particular market price reflects all material information. For the same reason, it should not be presumed that any particular trader in fact reasonably relied on a market price as reflecting the proper valuation of the underlying commodity. Even in the instance of purposeful dissemination of a false rumor, the impact, if any, of that rumor on market prices cannot be presumed. For example, persons with material nonpublic information that confirms to them the falsity of the rumor might trade in a manner that neutralizes any potential measurable impact of it on market prices.

We also note that a key premise for the courts in developing the FOMT was to reduce the evidentiary burden on private plaintiffs for proving reliance in SEC Rule 10b-5 fraud cases. The FOMT is based on the rationale that, while the federal securities laws require that all material public information should be equally available to all investors, retail investors do not have the resources to access and review all publicly disclosed material information and, therefore, in an efficient market, should be permitted to rely on the price of a security as a true reflection of that information. The theory was also driven by an interest to allow class actions in such cases. The Court in *Basic* explained that:

> Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones.[20]

There are no similar public policy considerations in the context of the futures and derivatives markets that would justify applying such a theory. These markets are comprised mostly of sophisticated commercial and institutional entities that have significant resources.[21]

> information regarding the company and its business . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . .

Basic, Inc. v. Levinson, 485 U.S. 224, 241-42 (1988).

[20] *Basic, Inc. v. Levinson*, 485 U.S. at 242.

[21] We note that the FERC staff may have, we believe, implicitly and mistakenly relied on FOMT as a means to try to sustain enforcement actions under the FERC's anti-manipulation rules based solely on alleged wrongful trading practices without an independent showing of deception or fraud. In certain enforcement matters, FERC staff in seeming reliance on the FOMT has argued that an alleged artificial price resulting from open market trading activity alone – without the commission of any *fraudulent* misrepresentations or omissions – constitutes fraud under its anti-manipulation rules. The FOMT does not support such contentions because, as its name suggests, a fraudulent misrepresentation or omission is an essential element of the theory and, as explained above, it is founded on premises for pricing securities that do not exist for commodity futures and derivatives markets.

D. A Commission Rule Under Section 6(c)(1) Should Require a Showing of All Elements of Manipulation, Including the Element of a Specific Intent to Cause an Artificial Price

In its Proposing Release, the Commission recognized that a Commission rule modeled on SEC Rule 10b-5 should be modified "as appropriate to reflect the CFTC's distinct regulatory mission and responsibilities."[22] Liability for manipulation under the CEA for futures markets has at least four elements: (1) the accused had the ability to cause artificial prices and (2) specifically intended to cause artificial prices, (3) artificial prices existed, and (4) the accused caused the artificial prices.[23] One of the required elements of manipulation under the CEA has been a showing of a specific intent to cause an artificial price. The Commission's landmark decision in *In re Indiana Farm Bureau Cooperative Association, Inc.*, held that in order to prove the element of intent for a manipulation or attempted manipulation claim under the CEA, "it must be proven that the accused acted (or failed to act) with the *purpose or conscious object* of causing or effecting a price or price trend in the market *that did not reflect the legitimate forces of supply and demand* influencing futures prices in the particular market at the time of the alleged manipulative activity."[24] The Commission has recently expressly reaffirmed this holding in *In re DiPlacido*.[25]

Market manipulation under Section 10(b) has similarly been characterized as a species of fraud that involves fraudulent conduct specifically intended to corrupt the integrity of market pricing processes through rigged prices, wash sales, fictitious trading, or false rumors.[26] These

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22 75 Fed. Reg. at 67,658.

23 *In Re Indiana Farm Bureau Coop. Ass'n*, 1982 WL 30249 at *7 (CFTC 1982).

24 *Id.* (emphasis added).

25 *In the Matter of Anthony J. Diplacido*, 2008 WL 4831204, (CFTC Nov. 5, 2008), *aff'd. DiPlacido v. CFTC*, 2009 WL 3326624 at *3, Comm. Fut. L. Rep. ¶ 31,434 (2d Cir. 2009) (unpublished summary order). *Accord, In re Cox*, [1986–1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786 at 34,061 (CFTC July 15, 1987).

26 *E.g., Ernst & Ernst v. Hochfelder*, 425 U.S. at 199 (the term manipulation "is and was virtually a term of art when used in connection with securities markets" that "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities"); *Santa Fe Indus., Inc. v. Green*, 430 U.S. at 476 (manipulation "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity"); *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 207 (3d Cir. 2007), *cert. denied*, 536 U.S. 923 (2002) ("essential element" of a claim of manipulation is that the violator injected inaccurate information into the marketplace or created a false impression of supply and demand for the security); *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99-100 (2d Cir. 2007) (manipulation requires a showing that an alleged manipulator engaged in market activity aimed at deceiving investors as to how other market participants have valued a security); *Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857, 864 (7th Cir. 1995) (defendant's "unprecedented massive short selling" – which involved short selling of more shares than existed – was not actionable because market rules permitted such trades and they were not intended to create and did not create "a false impression of supply or demand" because on the other side of the defendant's transactions were "real buyers, betting against [defendant], however foolishly, that the price of [the] stock would rise").

authorities are founded on the principle that intent to cause artificial market prices through fraudulent conduct is an intrinsic element of market manipulation. A rule that does not require evidence of a specific intent to cause artificial market prices as an element of a violation would result in a dangerously vague rule.

The following is a simple example of why the element of intent to cause false, fictitious and artificial market activity or pricing is necessary to distinguish legitimate trading from that involving manipulation of markets. Commodity trading ultimately is a competition among market participants for favorable prices and all trades affect market prices and perceptions to some extent. Commodity traders develop strategies to profit from the perceived future valuation of a commodity for the benefit of their commercial business or proprietary trading positions. Successful trading strategies require talent in commodity valuation, astute assessment of market sentiment and behavior, and the savvy and skillful execution of trades. To be successful, market participants must often guard information closely about their positions, intentions, vulnerabilities, weaknesses and strengths because the discovery of it by others in the market can allow them to quickly exploit the trader's weakness, destroy its strength, or otherwise change the market fundamentals that had supported the previously well-founded and prescient market analysis.

Trade execution strategies are affected by the legitimate need to guard proprietary trading information from discovery. Market participants will regularly, as a common and sometimes essential part of their trading strategies, employ trade execution strategies that are designed to camouflage their actual trading strategy, intentions and positions to prevent detection. For example, a trader that intends to establish or liquidate a large market position will commonly do so through multiple contemporaneous bids or offers at different prices made through multiple brokers in order not to reveal to any one broker or to other market participants the aggregate size of its trades, market positions or trading intentions.

A Commission anti-manipulation rule that does not require specific intent to cause an artificial price as an essential element of a violation could expose participants to the threat of arbitrary and unfair enforcement. In the example above, absent an element of a specific intent to cause an artificial price, the trader's execution strategy theoretically might be exposed to claims of manipulation on grounds that it causes other market participants to have a misperception about market liquidity. However, such trading practices have always been and should continue to be lawful market practice precisely because, where bids and offers are made and the trades executed at arm's length within regular market processes, with exposure to market risk, and without collusion, violation of market rules or any affirmative duty to disclose a bidder's or offeror's identity to the market, the elements of a specific intent to cause artificial prices cannot be established.[27]

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[27] The Committee notes that there were some comments in floor debates on the Dodd-Frank Act by certain members of Congress that indicate that Section 6(c)(1) was intended to introduce a recklessness standard for manipulation under the CEA and thereby to lessen the elements from the prior law under Section 9(a)(2). Congress's only express inclusion of a recklessness standard in Section 753 of the Dodd-Frank Act, however, was limited to the

Similarly, if a large number of OTC swaps are forced onto exchanges, it is likely that trading in some of these swaps will be relatively illiquid. Accordingly, they could be subject to rapid price movements and volatility as there could be wide bid/ask spreads. The rapid price movements could simply reflect the dynamics of market participants wanting to buy or sell in an illiquid market. Without an element of a specific intent to cause an artificial price, however, the bidding and offering of a market participant that naturally added to and in fact caused the extreme price movements could be wrongly characterized as manipulation even though that volatility is properly attributable to illiquidity.

Although the Commission has acknowledged that scienter is an important aspect of its interpretation of Section 6(c)(1), it also indicates an intention to make determinations of scienter on a case-by-case basis, with these determinations guided but not controlled by existing precedent under Section 10(b) of the Exchange Act. We believe that this approach may provide insufficient guidance for market participants trying to understand the parameters of a new regulatory system. We encourage the Commission to be more direct in its approach to scienter and specifically recognize that scienter must be tied to artificial prices.

E. Extreme Recklessness Is the Proper Standard for Scienter with Respect to the Fraud and Deception Requirement for Any Rule Under Section 6(c)(1)

In light of the fact that the Commission does not propose to not limit the scienter element for Section 6(c)(1) activity to knowing, intentional deception or fraud, it should make clear that extreme recklessness is required. In this, it should be guided by the Federal Trade Commission's ("FTC") approach in adopting anti-manipulation rules under Section 811 of Title VIII of the

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false reporting proscription in Section 6(c)(1)(A). It proscribes false reporting when acting in "reckless disregard" that a report "is false, misleading or inaccurate." That provision relaxes the scienter standard for civil violations of false reporting from the "knowing" *mens rea* standard required to establish a violation of the criminal offense of false reporting in CEA Section 9(a)(2) (*see U.S. v. Valencia*, 394 F.3d 352 (5th Cir. 2004), which Congress did not change in enacting the Dodd-Frank Act. Section 6(c)(1) does not expressly include a recklessness standard in proscribing employing any "manipulative or deceptive device or contrivance." A recklessness standard under Section 6(c)(1) could be inferred, however, by reasoning that (a) by using the language of Section 10(b) for Section 6(c)(1), Congress intended that prior accepted constructions of that language apply (*see also Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 374-82 (1982)), and (b) the existing construction of such language by the federal courts of appeals have affirmed that it embraces a recklessness standard. As discussed above, however, the Section 10(b) recklessness standard is applied to determine if an alleged violator was reckless with respect to whether its words or conduct *would deceive others as to a material fact.*

Energy Independence and Security Act of 2007 ("EISA"),[28] which looked to Exchange Act Section 10(b) precedent and adopted an extreme recklessness standard.[29]

With the enactment of Section 811 of EISA, Congress gave the FTC authority to prohibit market manipulation in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale. The FTC noted that the prohibition of the use or employment of any "manipulative or deceptive device or contrivance" in Section 811 of EISA was "virtually identical to the prohibition in Section 10(b) of the [Exchange Act]," and thus looked to securities case law to interpret the statute.[30] As discussed previously, in enacting Section 6(c)(1), Congress used the same language.

In *Ernst & Ernst v. Hochfelder*, the Supreme Court held that the terms "to use or employ" and "fraudulent or deceptive," as used in Section 10(b) of the Exchange Act, indicate that Congress intended to prohibit only knowing or intentional conduct.[31] In promulgating its final rule on the prohibition of manipulation, the FTC correctly noted that almost all the circuit courts have adopted the extreme recklessness standard. Hence, proving scienter in the FTC's markets requires a showing that a person's conduct presents a danger of misleading buyers or sellers that is either known to the actor or is so obvious that the actor must have been aware of its false and misleading nature.

Recklessness thus requires that the violator acted both with (i) an "extreme departure" from standards of ordinary care *and* (ii) the danger of misleading buyers or sellers that was either known to the defendant or was so obvious that the actor must have been aware of it.[32] This standard is appropriate because extreme recklessness connotes an element of willfulness that is consonant with the Supreme Court's definition of scienter under Exchange Act Section 10(b) as "a mental state embracing intent to deceive, manipulate, or defraud."[33] Thus, the standard provides for both effective anti-manipulation enforcement and clarity for market participants.

Such a rule also would conform the scienter element of the Commission's rule with the FTC's anti-manipulation rule for wholesale markets in crude oil, gasoline, or petroleum distillates. Any rule that imposes a lesser level of intent is likely to sweep too broadly and fail to distinguish unlawful conduct from legitimate market activity.

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28 Energy Independence and Security Act of 2007, Pub. L. No. 110-140, 121 Stat. 1492 (2007).

29 Prohibitions of Market Manipulation, 74 Fed. Reg. 40,686, 40,688 (Aug. 12, 2009).

30 *Id.*

31 *Ernst & Ernst v. Hochfelder*, 425 U.S. at 197-99.

32 Prohibitions of Market Manipulation, 74 Fed. Reg. 40,686, 40,691-92 (Aug. 12, 2009) (citing *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977)). *See, e.g.*, authorities cited *supra* at note 6.

33 *Ernst & Ernst v. Hochfelder*, 425 U.S. at 193, n.12.

F. The Commission Should Make Clear That Neither a Rule under Section 6(c)(1) nor the Proscriptions in New CEA Section 4c(a)(7) Impose Any New Duties of Inquiry, Diligence or Disclosure

The Commission should make clear that its anti-manipulation rule under Section 6(c)(1) does not create any new duties of inquiry, diligence or disclosure to parties to futures, options, swaps or cash commodity transactions. Section 6(c)(1) not only does not articulate any new affirmative duties or obligations, it expressly prohibits the promulgation of any rule that would 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 to make any statement made to the other person in or in connection with the transaction not misleading in any material respect. That prohibition is consistent with the longstanding principle, as discussed above, that commodity market participants generally have no independent, affirmative disclosure obligations and are entitled to trade on the basis of material, nonpublic information. The Commission should reconfirm this principle in the final rule it adopts under Section 6(c)(1).

Section 747 of the Dodd-Frank Act makes it unlawful under the new Section 4c(a)(7):

> 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" of the CEA.

Nothing in Section 4c(a)(7), however, imposes a duty of inquiry or diligence to determine what use or the effect of any use a counterparty may make of a swap.

Imposing new duties of inquiry, diligence or disclosure would be contrary to the relationship between the sophisticated, arm's-length, competing counterparties that participate in futures, swaps and cash commodity markets by expressly or impliedly creating an obligation to disclose one's own and obtain a counterparty's confidential, proprietary, and very often competitively sensitive trading information. This would be deleterious to the healthy functioning of the derivatives markets, force such trading markets off-shore, and inappropriately increase compliance and transactional costs associated with trading.

The Commission thus should make it clear that its anti-manipulation rule will be violated only if a party violates a pre-existing duty arising under contract, common law or some other non-CEA source. Firms should not have to disclose commercially and competitively sensitive information, gained through the significant investment and devotion of their own resources, to any other person or entity absent a pre-existing legal obligation to do so. Merely failing to provide such information should not establish a violation even if the counterparty can show that, but for

such failure, it would have acted differently. The Committee notes that both the FTC and FERC provided such clarity in promulgating their market manipulation rules.[34]

V. Congress Intended That Section 6(c)(3) Apply Only to Manipulation, if Any, Outside the Ambit of Section 6(c)(1)

Congress included Section 6(c)(3) to leave no doubt that enactment of Section 6(c)(1) does not limit the Commission's ability to prosecute civilly any non-fraud based manipulation. This is consistent with, for example, the *DiPlacido* precedent that charged manipulation for floor trading practices that were not alleged to be intrinsically fraudulent. We also support the Commission's clarification in its Proposing Release to reaffirm the traditional four-part test needed to sustain a manipulation charge under Section 6(c)(3). In accordance with the Commission's affirmation of the four-part test, Section 6(c)(3) and Section 9(a)(2) are the proper provisions to bring non-fraud based manipulation charges. This means that to prove a claim under Section 6(c)(3) in an enforcement action against, for example, an alleged market power manipulation, it must be shown, among other things, that the accused specifically intended to cause an artificial price. We also note, however, that the statutory basis for proposed rule 180.2 under CEA Section 8a(5) is not clear because it is not clear that a rule that merely repeats the statutory prohibition is necessary or appropriate.

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[34] Prohibitions of Market Manipulation, 74 Fed. Reg. at 40,698; Prohibition of Energy Market Manipulation, 71 Fed. Reg. at 4251.

The Committee appreciates the opportunity to comment on the Commission's proposed rules, and we respectfully request that the Commission consider the recommendations set forth above. Members of the Committee are available to discuss these comments should the Commission or the staff so desire.

Respectfully submitted,

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