CME Group

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VIA ELECTRONIC MAIL

January 3, 2011

David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
secretary@cftc.gov

Re: Notice of Proposed Rulemaking on Prohibition of Market Manipulation – RIN #: 3038-AD27

Dear Mr. Stawick:

CME Group Inc. ("CME Group"), on behalf of its four designated contract markets ("Exchanges"), appreciates the opportunity to comment on the Commodity Futures Trading Commission's (the "CFTC" or "Commission") Notice of Proposed Rulemaking ("NOPR" or "*Release*") with respect to Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") – titled Anti-Manipulation Authority.

CME Group shares Congress' and the Commission's objective of promoting transparency and integrity in financial markets, and doing so in a manner that preserves the vibrancy and competitiveness of U.S. markets in the global economy. Market integrity is one of the cornerstones of CME Group's business model, and the company employs substantial human resources and technological capabilities to protect and continually enhance the integrity of its markets and mitigate the potential for market disruptions. We recognize that our customers' confidence in that commitment is essential to our ability to draw participants and liquidity to our markets and allows us to effectively serve the risk management and price discovery needs of users around the globe.

CME Group is the world's largest and most diverse derivatives marketplace. CME Group includes four separate Exchanges, including Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products.

CME includes CME Clearing, one of the largest central counterparty clearing services in the world, which provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter derivatives transactions through CME ClearPort®.

The CME Group Exchanges serve the hedging, risk management and trading needs of our global customer base by facilitating transactions through the CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, as well as through privately negotiated transactions.

I. INTRODUCTION

We believe that there is a shared interest among market participants, exchanges, and regulators in having market and regulatory infrastructures that promote fair, transparent and efficient markets and that mitigate exposure to risks that threaten the integrity and stability of markets. We believe that there is also a shared interest among market participants, exchanges, and regulators in operating under a set of rules that clearly define impermissible conduct and having confidence that the governing disciplinary regime is applied fairly and rationally. Indeed, if market participants do not know the rules of the road in advance and lack confidence that the disciplinary regime will operate fairly and rationally, market participation will be chilled because there is significant risk that legitimate trading practices will be arbitrarily construed, post-hoc, to be unlawful.

In the NOPR, the Commission proposes two rules. The first rule, Rule 180.1, is being proposed pursuant to Section 753 of Dodd-Frank, which grants the Commission general manipulation authority. Section 753 is based on Section 10(b) of the Securities Exchange Act, and the Commission's proposed Rule 180.1 is based on the Securities Exchange Commission's Rule 10b-5. The second rule, Rule 180.2, is being proposed pursuant to the Commission's general rulemaking authority, and mirrors the language in CEA Section 6(c)(3), which specifically prohibits price manipulation. As written, proposed Rules 180.1 and 180.2 are vague and fail to provide market participants with sufficient notice of whether contemplated trading practices run afoul of these Rules.

With respect to proposed Rule 180.1, the Commission relies completely on Rule 10b-5 and the body of case law that exists interpreting that Rule. Although the language in Section 753 is based on Section 10(b) of the Securities Exchange Act and the Securities Exchange Commission's Rule 10b-5, Rule 10b-5 was adopted and applied in a totally different market and, consequently, different regulatory context. The securities markets focus on capital raising investments where disclosure of all material market information is the desired outcome and where special regulatory structures have been established for those disclosures. Moreover, the regulation of securities markets is focused to a substantial extent on protecting retail investors and is intended to provide a forum to trade securities on a level playing field where insiders and those they "tip" are precluded from trading on the basis of inside information.

In contrast, nothing in the CEA mandates disclosure of market conditions or facts pertaining to the markets for commodities, including energy, interest rates and corn.[1] As the Commission

1 Commission Rule 1.59(d) prohibits exchange governing board members, committee members, members, employees and consultants from disclosing or trading in any commodity interest on the basis of material, nonpublic information obtained through their official exchange duties. Furthermore, this rule also prohibits any person from trading in any commodity interest, whether for such person's own account or on behalf of another person, on the basis of material, nonpublic information that such person knows was obtained in violation of Commission rule from an exchange governing board member, committee member, member, employee or consultant. See also CEA §9(e).

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knows, the markets it regulates serve a price discovery function for the underlying commodities. An effective forum for the efficient discovery of prices requires that hedgers, who have information based on their operations, and speculators, who accumulate information in order to profit, be encouraged to bring that information to the market in the form of bids and offers. Indeed, the price discovery function is optimized when all market information known to hedgers or to speculators is reflected in the market price of a given contract. In addition, these markets, which react to world-wide supply and demand factors, have different "material information" considerations than markets that focus on the fortunes of a single company. Thus, futures, options, swaps and physical commodity markets are quite different than securities markets. As discussed in more detail below, the proposed rule's failure to account for these differences results in a lack of clarity for market participants.

With respect to proposed Rule 180.2, the Commission also states in the Release that it will continue to interpret price manipulation and attempted price manipulation prohibitions "to encompass every effort to improperly influence the price of a swap, commodity or commodity futures contract. (75 FR 67658.) Even if this statement did not conflate an "attempt" with actual price manipulation (as it clearly does), it provides no guidance to market participants as to what types of conduct would qualify as an "effort to influence", nor does it explain how market participants can distinguish an "improper" effort from a "proper" effort.

Is it improper for a market participant to seek legislation from Congress to increase the use of natural gas while he holds natural gas interests? Is he required to disclose his interests in natural gas in connection with his statements? What if the market participant merely is interviewed by the media and expresses a view that natural gas is under-utilized and under-valued today? Is it improper for a farmer, to make public statements regarding potential shortages in a years' supply of corn if the farmer holds an interest in an ethanol refinery? Would the farmer be required to disclose any financial interests in that refinery in conjunction with these statements? As discussed in more detail below, additional elements of this rule require additional clarity from the Commission.

To promote fair and efficient markets and protect market liquidity and the price discovery and risk management functions served by the futures markets, the Commission must revise its proposed rules and provide greater clarity to market participants regarding the scope of prohibited conduct. Additionally, without further guidance from the Commission, the proposed rules are susceptible to constitutional challenge because due process precludes the government from penalizing a private party for violating a rule without first providing adequate notice that his contemplated conduct is forbidden by the rule.[2] As a result, courts will dismiss prosecutions, frustrating the Commission's enforcement efforts. Set forth below are our detailed comments for the Commission's consideration in promulgating final rules to address its new anti-manipulation authority under Dodd-Frank.

II. DETAILED COMMENTS

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2 *See, e.g., U.S. v. Radley*, 659 F.Supp.2d 803, (S.D. TX. 2009) (finding that the CEA's prohibition of price manipulation was unconstitutionally vague as applied to defendants); *see also Satellite Broad. Co.* v. *FCC*, 824 F.2d 1, 3 (D.C. Cir. 1987) ("Traditional concepts of due process incorporated into administrative law preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule.").

A. Proposed Rule 180.1, unlike SEC Rule 10b-5 on which it is modeled, should not prohibit any market participant from trading on non-public "inside" information

In its *Release*, the Commission proposes implementing a rule modeled on SEC Rule 10b-5, but "with modification to reflect the CFTC's distinct regulatory mission and responsibilities." CME Group agrees with the Commission's assessment that fundamental differences exist between the securities and futures markets and believes that, in accordance with the CFTC's distinct regulatory mission and responsibilities in regulating futures markets – which are much different from securities markets – the Commission should confirm that it will not import insider trading law from SEC Rule 10b-5 into its regulatory framework. Such rules are and should be inapplicable to futures markets.

"Insider Trading" refers to buying or selling securities on the basis of material, nonpublic information in breach of a duty; in securities markets, insider trading violates Section 10(b) of the Exchange Act and SEC Rule 10b-5. The CEA does not prohibit and has never prohibited market participants from trading on the basis of material nonpublic information, unless the participant has received a tip from a government or self-regulatory official. The reason for this difference in futures and securities regulation lies in the basic differences in futures and securities markets. As recognized in "A Joint Report of the SEC and the CFTC on Harmonization of Regulation" (October 16, 2009) ("2009 Report"), securities markets are concerned with the formation of capital, and this capital formation role gives rise to the interest in promoting disclosure in securities regulations. That is, a central principle in equity markets is ensuring that all market participants have equal access to material information. Insider trading prohibitions are intended to prevent corporate insiders from misusing of inside information at the expense of their shareholders.

As the Commission knows, the purpose of futures markets is not capital formation but rather to facilitate the management and transfer of risk. Commodities regulation does not provide a regulatory regime for the disclosure of the macro-economic information that concerns the supply and demand dynamics that affect commodity prices and is designed, in part, to promote the interests of hedgers to protect themselves against commodity price risks based on their own knowledge of material nonpublic information about supply and demand conditions and the needs of their businesses. *See also*, *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537, 543 (7th Cir. 1989) ("securities usually arise out of capital formation and aggregation (entrusting funds to an entrepreneur) while futures are means of hedging, speculation, and price revelation without transfer of capital. The distinction between the jurisdiction of the SEC and that of the CFTC can be described as the difference between regulating capital formation and regulating hedging").

The use of inside information by a company to hedge its risks is integral to futures markets. Many key participants in futures markets have legitimate access to what could be described as "superior" information. ("A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information" (September 1984) at 53) ("1984 Study"). Hedgers are privy to nonpublic information that may be material to the futures markets. (*Id.*) Speculators have knowledge of their own positions and may also have superior resources with which to purchase or develop information. (*Id.*) This superior access to information is inherent in futures markets, and market participants voluntarily accept this situation if they choose to trade. (*Id.* at 54.)

Moreover, the relationships and duties that give rise to insider trading liability in the securities markets simply do not exist in the futures markets. Insider trading liability is reliant on the fiduciary relationship between corporate insiders and their shareholders. *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (citing *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)). That is, "application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information." *Id.* This fiduciary duty, which gives rise to liability for insider trading, does not exist in futures markets. No fiduciary relationship exists between an "insider" and a person on the opposite side of a trade in a futures market. *See* 1984 Report at 56; 2009 Report at 7. Rather, corporate insiders' duties are to ensure that the company properly manages its risks by trading on the best available information. (2009 Report at 7.) As such, there is no basis for general insider trading liability in futures markets, because trading by persons with "inside information" does not raise the same concerns it raises in the securities market. (2009 Report at 60.) In fact, the Commission has found that insider-type trading is, at least in part, what causes the futures market's price discovery process to work. In its 1984 study on insider trading in futures markets, the Commission did not even consider the possibility of applying insider trading law to a hedger. (1984 Report at 8.) To the contrary, it stated:

> The ability of any person to capture the value of his or her proprietary information is a traditional prerogative of commercial enterprise. Because the futures markets are derivative, risk-shifting markets, it would defeat the market's basic economic function – the hedging of risk – to question whether trading based on knowledge of one's own position were permissible. Accordingly, consistent with the Congressional mandate, trading on the basis of one's own cash or futures markets positions is exempt from any discussion of insider trading.

(*Id.* at 8.) In that same study, the CFTC recognized that insider trading may provide "a vehicle to enhance the pricing efficiency of futures markets." (*Id.* at 52.) Trading on the basis of material nonpublic information in futures causes the transmission of information regarding accurate pricing for a commodity into the futures market, therefore allowing more accurate commodity prices to be reflected in the market even absent disclosure of the nonpublic information available to the trader. (*Id.* at 44, 47.) Futures trading based on nonpublic material information actually enhances the informational efficiency of the market by expediting the incorporation of new information in the market price via the bids and offers of an insider. (*Id.* at 48.) For all of these reasons, the CFTC did not recommend full insider trading liability under the CEA in either its 1984 Study or its recent 2009 Report. Specifically, in that most recent report, the SEC and CFTC recommended only that the CEA be amended "to make unlawful the misappropriation and trading on the basis of material non-public information from any governmental authority." (2009 Report at 13.) In Dodd-Frank, Congress adopted that recommendation into the CEA. See CEA § 4c(a)(3) and (4).

In addition to "traditional" SEC insider trading liability, courts have also recognized fairly recently a "misappropriation" theory of insider trading. The relatively new "misappropriation" theory should not be applied to commodities markets or, at most, should be applied only in extremely limited circumstances. Under the misappropriation theory, a person commits fraud in connection with a securities transaction and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." That is, "in lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). Misappropriation theory "is designed to 'protect the integrity of the securities markets against abuses by outsiders to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders." *Id.* at 653 (internal citation omitted).

Like traditional insider trading, liability based on misappropriation should not be applied to futures markets. Although not directly related to the fiduciary duty of a corporate insider to the corporation's shareholders, misappropriation liability still relies on the concern of equity markets that all participants have equal access to information. That concern, as discussed above, simply does not exist in futures markets and as such, misappropriation liability is not necessary to protect equal access to information. *See, e.g., O'Hagan*, 521 U.S. at 2207 (noting that misappropriation theory is "designed to 'protect the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed"); *SEC v. Rocklage*, 470 F.3d 1, 11 (1st Cir. 2006) (noting the investor protection purposes of 10(b) in the context of misappropriation). Other concerns addressed by misappropriation liability, such as breaches of fiduciary duty, are easily and best dealt with through other actions, such as state law actions for breach of fiduciary duty and unjust enrichment. Indeed, in the 2009 Report, the Commission recommended that misappropriation liability only be applied to futures markets in one extremely limited context: when an individual acquires material non-public information from a government authority. (2009 Report at 92.)

B. The Commission should not impose an affirmative duty to provide market-wide disclosure nor an expansive duty to correct upon participants in futures markets

Section 6(c)(1) provides that no CFTC rules "shall require any person to disclose to another person nonpublic information that may be material to the market price, rate, or level of the commodity transaction, except as necessary to make any statement made to the other person in connection with the transaction not misleading in any material respect." The CFTC adopts this language in its proposed Rule 180.1(b). It is unclear from the *Release*, however, whether the CFTC intends this language to prohibit an affirmative duty to disclose as applied to only bi-lateral negotiations or also to multiple party and market-wide disclosures. CME Group believes that the statute's bar on affirmative disclosure and the CFTC's rules should apply to both.

The statutory language indicates that proposed Rule 180.1(b) should apply to both bilateral negotiations and market-wide disclosure. Proposed Rule 180.1 is promulgated under Section 6(c)(1), which is not limited by its terms to bilateral negotiations. Indeed, similar provisions directly applied to bilateral negotiations already appear in Section 4b. Regardless, imposing any duty to affirmatively disclose information is improper because in futures markets, there is no right to any information before trading, let alone roughly equal, issuer-sponsored, material information.

Additionally, the language of Dodd-Frank and the proposed rule leave open the possibility of a requirement that a participant in the futures markets be required to disclose information "necessary to make any statement made to the other person in or in connection with a transaction not misleading in any material respect." First, CME Group asks that the Commission confirm that it is not placing any new duty of disclosure akin to that in securities markets upon participants in futures markets in promulgating this rule. Second, CME Group suggests that the Commission narrowly circumscribe any potential requirement to correct an inaccurate statement. Such a requirement could best be circumscribed to require only disclosure to correct a statement that a futures market participant realizes was incorrect when that participant made a statement if the participant realized that the statement was incorrect within a reasonable time after making it. If such requirement to correct is not properly circumscribed, it could very quickly morph into a general affirmative duty to disclose, which, as discussed at length above, has no place in the regulation of the futures markets. Assume, for example, that a market participant is asked whether it has a contract to export, and it truthfully answers that it does not. Does it then have to correct that statement if circumstances change before it hedges a contract entered into a week later? What about a month or a year later? This situation, if not circumscribed, becomes an inappropriate ongoing duty to disclose proprietary information.

In sum, CME Group is concerned that the Commission may, through its proposed Rules, apply securities laws to futures markets that are first, inapplicable to futures markets and second, clearly detrimental to the proper functioning of futures markets. More specifically, CME Group suggests that the application of insider trading law to futures markets would, most notably, inhibit the ability of hedgers to protect against risk based upon their knowledge of their own businesses and positions and would, consequently, inhibit the price discovery function of futures markets. Additionally, a broad application of a duty to correct could become a general affirmative duty to disclose which, like insider trading laws, is not warranted in futures markets. As such, CME Group suggests that the Commission confirm that: 1) it does not intend, through proposed Rule 180.1, to impose insider trading liability, either under the traditional or misappropriation theory, upon participants in futures markets; 2) it does not intend to impose a duty to disclose nonpublic information either in the context of an individual transaction or in the context of a multi-party or market-wide disclosure. Further, CME Group suggests that the Commission very narrowly circumscribe any potential duty to correct a statement in order to render it not materially misleading.

In seeking to clarify the nature and scope of the prohibitions under its proposed Rule 180.1, the Commission should refrain from blanket application of SEC Rule 10b-5 concepts and standards to the commodities and derivatives markets. CME Group has long maintained, consistent with positions the Commission itself has taken, that the precedent developed in the securities fraud context is *largely* inapplicable to CFTC-regulated markets due to key differences in the market structures discussed earlier (i.e. types of market participants, applicable duties, material information considerations, However, CME Group believes that the Commission can and should borrow concepts from the SEC's anti-fraud and anti-manipulation framework, as well as that of other agencies, where doing so would allow for sensible regulation of the commodities and derivatives markets. For the reasons stated below, CME Group particularly supports the Commission being "guide[d], but not control[led],"[3] by other agencies', including the SEC's, standards for scienter and the "in connection with" requirement.

C. The Commission Should Adopt a Scienter Standard that Requires, at Minimum, a Showing of "Extreme Recklessness"

[3] The Commission uses this specific phrase in its Notice of Proposed Rulemaking when discussing the weight to be given judicial precedent from the securities context, and further comments that its proposed rule 180.1 (particularly the scienter standard) must be applied "in a manner that comports with the purposes of the CEA and the functioning of markets regulated by the CFTC." 75 Fed. Reg. 67657, 67659 (Nov. 3, 2010).

The proposed rule fails to define with sufficient particularity the conduct that is prohibited. That failure creates significant issues as to the validity of the rule, which may be slightly mitigated if the intent or knowledge prerequisite to a violation is carefully defined. In its NOPR, the Commission states that "scienter" in the context of proposed Rule 180.1, just as with the similarly worded SEC Rule 10b-5, "refers to a mental state embracing intent to deceive, manipulate or defraud, and [ ] includes recklessness" but excludes negligent and grossly negligent conduct. (75 Fed. Reg. at 67659.) CME Group urges the Commission to clarify what it considers to be "recklessness" for purposes of its proposed rule. Further, CME Group recommends that the Commission model its standard for recklessness on the thresholds adopted by courts in the securities fraud context and by the FTC. At the very least, "recklessness" should require conscious disregard for the near certainty that one's actions will result in deception, manipulation or fraud.

Even in securities law cases, where one might think that a lower scienter standard would be used in the interest of protecting retail investors, the requisite level of "recklessness" is very high. All of the Circuit Courts of Appeal have decided that, in addition to intentional misconduct, only recklessness that is "extreme" or "severe" will satisfy the scienter standard under Exchange Act Section 10(b) and SEC Rule 10b-5.[4] "Extreme recklessness" is generally defined in the applicable case law as conduct that "involves an extreme departure from the standards of ordinary care and which presents a danger of misleading buyers and sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *See, e.g., Sundstrand Corp.*, 553 F.2d at 1045. In *In re Silicon Graphics Inc.*, the Ninth Circuit observed that the words "known" and "must have been aware" suggest that extreme recklessness involves consciousness or deliberateness and therefore is a degree of intentional misconduct. 183 F.3d at 977.

The rationale behind adopting this high threshold for recklessness in the securities context is compelling and applies with equal or greater force to CFTC-regulated markets: an ordinary recklessness standard, capturing inadvertent conduct or mistakes, would discourage legitimate market activity. Indeed, in *Novak v. Kasaks*, the Second Circuit explicitly identified several types of legitimate practices that would not come within the understanding of "extreme recklessness." 216 F.3d at 309. For one, the court noted that a defendant would not be liable for securities fraud based on reckless conduct if he commits "fraud by hindsight" – i.e. makes projections or forward-looking statements that are shown *after the fact* to have been unwarranted. *Id.* The basic principle underscored by the Second Circuit in *Novak* (and echoed by every other circuit court) that a person should only be punished for knowing or intentional wrongdoing is not only relatively easy for regulators to apply, but is also readily grasped by market participants.

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[4] *See Rockies Fund v. SEC*, 428 F.3d 1088 (D.C. Cir. 2005); *Ottmann v. Hanger Orthopedic Group, Inc.*, 352 F.3d 338 (4th Cir. 2003); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245 (10th Cir. 2001); *Florida State Board of Administration v. Green Tree Financial Corp.*, 270 F.3d 645 (8th Cir. 2001); *Nathenson v. Zonagen Inc.*, 267 F.3d 400 (5th Cir. 2001); *Howard v. Everex Systems, Inc.*, 228 F.3d 1057 (9th Cir. 2000); *Novak v. Kosaks*, 216 F.3d 300 (2d Cir. 2000); Bryant *v. Avardo Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999); *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970 (9th Cir. 1999); In *re Comshare, Inc. Securities Litigation*, 183 F.3d 542 (6th Cir. 1999); *In re Advanta Corp. Securities Litigation*, 180 F.3d 525 (3d Cir. 1999); *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977).

The Federal Trade Commission (FTC) has also adopted an "extreme recklessness" standard for its final rule on the prohibition of market manipulation. *See* 74 Fed. Reg. 40686, 40691 (Aug. 12, 2009). The FTC clarified, however, that its definition of extreme recklessness would not require a departure from "ordinary care" because "whereas standards of ordinary care are well developed in the context of securities markets, they are less well defined in the context of wholesale petroleum markets." *Id.* at 40692. Thus, the FTC's extreme recklessness standard "require[s] showing only that a person either knew or must have known that his or her conduct created a danger of misleading buyers or sellers." *Id.* The FTC's reason for adopting this high threshold is the same as the one underlying the securities fraud cases discussed above: to provide both for clarity to market participants and effective rule enforcement. In the FTC's own words, the extreme recklessness standard "appropriately focuses [the broad anti-fraud prohibition] on conduct that presents an obvious risk of misleading buyers and sellers, and ensures that [the prohibition] does not reach inadvertent mistakes, which could have the unintended effect of curtailing beneficial market activity." *Id.* at 40694.

CME Group encourages the Commission to adopt an "extreme recklessness" standard for the same reasons articulated by the FTC and by the courts in the securities case law addressing scienter under SEC Rule 10b-5. CME Group believes that such a standard strikes an appropriate balance between protecting the integrity of competitive markets and allowing for legitimate competition, thereby ensuring that the liquidity and depth of the CFTC-regulated markets, which promote the public interests served by these markets (CEA §3(a)), will not be impaired. In terms of the precise definition of "extreme recklessness," CME Group suggests that the Commission use the FTC's formulation, which does not require a showing of a departure from "ordinary care." CME Group agrees with FIA that the FTC's reasoning that standards of ordinary care are "not well developed," in wholesale petroleum markets and should not be used in formulating applicable recklessness standards, "applies equally to all other commodities and derivatives markets." *See* FIA Comments at 7.

D. The Commission Should Interpret the "In Connection With" Standard to Require a Nexus Between Transactions (or Offers to Transact) Subject to CFTC Jurisdiction and Prohibited Fraudulent or Deceptive Conduct

The "in connection with" language of the CFTC's statutory authority for its anti-manipulation rules (new CEA Section 6(c)(1)) is noticeably different in scope from the parallel statutory language of other agencies. Whereas the SEC, FTC, and Federal Energy Regulatory Commission (FERC) have the authority to prohibit fraud-based manipulative schemes "in connection with the *purchase or sale of*" products subject to their jurisdiction,[5] the CFTC has the authority to prohibit such schemes "in connection with" products themselves – namely, "any

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[5] For the full text of the SEC's statutory anti-manipulation authority, including the "in connection with" language, see 15 U.S.C. § 78j (implementing provisions of the Securities Exchange Act of 1934, June 6, 1934, ch. 404, title I, Sec. 10, 48 Stat. 891, as further amended).

For the full text of the FTC's statutory anti-manipulation authority, including the "in connection with" language, see 42 U.S.C.A. §§ 17301-17305 (implementing provisions of the Energy Independence and Security Act of 2007, Pub. L. No. 110-140, 121 Stat. 1723).

For the full text of the FERC's statutory anti-manipulation authority, including the "in connection with" language, see 16 U.S.C. § 824v and 15 U.S.C. § 717c-1 (implementing provisions of the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594).

swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity." The sheer breadth of the CFTC's "in connection with" language – absent the "purchase or sale of" limitation found in comparable agency statutes – creates a specter of serious unintended consequences. For example, the prohibition on fraud or deception "in connection with . . . any commodity" sweeps so broadly that, on its face, it could even subject someone to liability for putting out a deceptive weather forecast or supermarket advertisement.

To ensure that the CFTC's "in connection with" standard does not cover conduct that Congress could not have meant to proscribe through the CEA's new provision, some context or limitation must be read into the statute and the Commission's proposed rule, which tracks the statutory language. In its NOPR, the Commission seems to import a limitation from the securities context, stating that "in connection with" under CEA Section 6(c)(1) should have the same meaning as the Supreme Court gave those words in *SEC v. Zandford*: "that is, where the scheme to defraud and the *transactions* subject to the jurisdiction of the Commission 'coincide.'" 75 Fed. Reg. at 67659 (emphasis added). In *Zandford*, the Supreme Court found that the "in connection with" requirement was satisfied because the defendant's fraudulent scheme "coincided" with the sale of securities. 535 U.S. 813, 822 (2002). CME Group supports the Commission's use of this precedent to add necessary gloss to the "in connection with" language in its statutory authority and proposed rule. Given that CEA Section 6(c)(1) and proposed Rule 180.1 also cover "attempts" to use or employ fraudulent schemes, CME Group would add the caveat that the "in connection with" test could be satisfied when fraud coincides with an *offer* to transact as well as when it coincides with an actual transaction (e.g. purchase or sale of futures contracts).

CME Group does not agree, however, with the Commission's reliance on other SEC precedent in proposing that the "in connection with" requirement would be met "whenever misstatements or other relevant conduct are made in a manner reasonably calculated to influence market participants." 75 Fed. Reg. at 67659-60. The securities case law cited by the Commission actually refers to how SEC Rule 10b-5 is violated when false or misleading "assertions are made . . . in a manner reasonably calculated to influence the *investing public*." *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (emphasis added). This broad, flexible interpretation of "in connection with" in SEC enforcement actions stems from the need to accomplish a fundamental purpose of the *Exchange Act* – that is, to protect *investors* from fraud, which is often perpetrated by a corporation's issuance of misleading statements. *See SEC v. Rana Research*, 8 F.3d 1358, 1362 (9th Cir. 1993). Unlike CFTC-regulated markets, the securities markets are composed almost exclusively of such investors who will flee if they are purposefully disadvantaged through fraud, deceit, or other abuse. In light of the different structure of the CFTC-regulated markets (very little retail investor participation) and distinct purposes of the CEA, which largely focus on protection of price integrity, rather than retail investor protection, CME Group submits that the Commission should not apply this SEC precedent in interpreting the "in connection with" requirement under CEA Section 6(c)(1) and proposed Rule 180.1. In futures and other derivative trading, conduct by market participants may be undertaken to influence other market participants for perfectly legitimate reasons, with no motive to deceive or harm others.

E. The Commission Should Clarify the Prohibition on False Reporting in Proposed Rule 180.1(a)(4)

The Commission's proposed Rule 180.1(a)(4) prohibits any person from delivering or attempting to deliver "a false or misleading or inaccurate report concerning crop or market conditions that affect or tend to affect the price of any commodity in interstate commerce, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate." This "false reporting" prohibition is similar to the one found in CEA Section 9(a)(2),[6] but raises an issue that requires clarification. Specifically, the Commission should provide clarification regarding the interplay between the proposed false reporting prohibition under new CEA Section 6(c)(1) and the false reporting prohibition in Section 9(a)(2). The former proscribes knowing *or* reckless conduct while the latter criminalizes only knowing conduct. New CEA Section 6(c)(1)(B) states, and the Commission reaffirms in its NOPR, that the Commission's authority under Section 9(a)(2) is not affected by new Section 6(c)(1). Thus, CME Group seeks the Commission's confirmation that only false reporting done *knowingly* will continue to be subject to the criminal penalties under Section 9(a)(2).

F. The Commission Should Clarify its Interpretation of the Concept of Price Manipulation and of the Traditional Four-Part Price Manipulation Framework

The Commission's proposed Rule 180.2 prohibiting price manipulation and attempted price manipulation codifies new CEA Section 6(c)(3), which extends the pre-Dodd Frank price manipulation prohibition to cover swaps in addition to commodities and commodity futures contracts. In applying the proposed rule, CME Group believes that the Commission should employ a bright-line test that distinguishes prohibited manipulative conduct from legitimate competitive trading activities. CME Group supports the Commission's statement reaffirming the continued applicability of the four-part traditional framework for price manipulation. *See* 75 Fed. Reg. at 67660. That analytical framework is both familiar to market participants and relatively focused in that it requires proof that: 1) the alleged manipulator had the ability to influence market prices; 2) the alleged manipulator specifically intended to do so; 3) artificial prices existed; and 4) the alleged manipulator caused the artificial prices.

However, similar to FIA, CME Group finds that the Commission's *interpretation* of the general concept of "manipulation" and the specific four-part test – particularly the "existence of artificial prices" element – requires further clarification. The Commission itself acknowledges that its reading of the term manipulation is "broad," encompassing "every effort to influence the price of a swap, commodity, or commodity futures contract that is intended to *interfere with legitimate forces of supply and demand in the marketplace.*" 75 Fed. Reg. at 67660 (emphasis added). Although CME Group appreciates that manipulation cases are fact-intensive and that the relevant law will "evolve largely on a case-by case basis," *Id.*, CME Group maintains that market participants must be provided with some clear ex ante guidance or line-drawing for the manipulation prohibition to be meaningful. Hence, <u>CME Group urges the Commission to clarify what factors or types of activity the Commission considers to be "intended to interfere with the legitimate forces of supply and demand</u>.

For the Commission's consideration, CME Group posits the following examples of market activities that have been criticized by others as *interfering* with the forces of supply and demand,

6 CEA Section 9(a)(2) makes it "a felony punishable by a fine of not more than $1,000,000 or imprisonment of not more than 10 years, or both, together with the costs of prosecution, for: [a]ny person . . . knowingly to deliver or cause to be delivered for transmission through the mails or interstate commerce by telegraph, telephone, wireless, or other means of communication false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce."

but could be viewed as simply forming *part* of the supply and demand dynamic in the marketplace:

- Commodity index fund trading: Such trading has been seen by some in the private and public sectors as blunting the effects of supply and demand through passive, "long only" investments. In the September 2008 CFTC Staff Report on Commodity Swap Dealers and Index Traders, however, staff noted that commodity index investors' objective is to "capture a commodity exposure" that serves the important purpose of portfolio diversification. *See* CFTC Staff Report at 40.

- Exchange-traded funds (ETFs): ETFs that buy and hold physical commodities could be said to be designed by "longs" to take supply out of the supply and demand equation and therefore boost prices. On the other hand, investors in ETFs or any other market participants employing a buy and hold commodity strategy, should be considered to be merely taking a "long" market view based on their assessment of the forces of supply and demand.

- Block Trading: This type of trading, which involves large private purchase or sale orders which if they had been entered directly on even the most liquid market could have had a perceptible short term effect on prices. Yet, block trades are completely legal when undertaken in accordance with exchange rules and actually *avoid* influencing prices given that the customer initiating the block and seeking "size" does not want to pay more as the market "runs away."

As the Commission assesses the legitimacy of the aforementioned activities and others, CME Group urges the Commission to bear in mind that a market participant's desire to seek the best available price should not be confused with an intention to interfere with the basic forces of supply and demand. *See In re Hohenberg Bros.*, [1975-1077 Transfer Binder] No. 75-4, Comm. Fut. L. Rep. (CCH) ¶10,025, ¶10,065, ¶10,175 and ¶10,310 (intent requirement not met where respondents decided to tender large delivery of certified cotton on futures market, as opposed to selling commercially, in order to obtain best price for cotton, notwithstanding that large tender generally has depressant effect on futures price); *see also United States v. Reliant Energy Services, Inc.*, 420 F. Supp. 2d 1043, 1059 (N.D. Cal. 2006) ("A seller of a commodity is acting quite rationally *and legally* to withhold his supply from the market if he believes that in the future the commodity will command a higher price – assuming, of course, the seller is under no legal duty to sell.") (emphasis in original).

With respect to the specific four-part manipulation test, the <u>Commission also should clarify how to determine whether a price has been affected by illegitimate factors</u> – in other words, whether a price is "artificial" as required by the third element of the test. The NOPR expresses the Commission's intent to adopt what is essentially a "we-know-it-when-we see-it" approach "in various circumstances." *See* 75 Fed. Reg. at 67660. That is, the Commission would "often" conclusively presume an illegal effect on price based on "the actions of the alleged manipulator." *See id.*

The case law cited in the Commission's proposal, however, does not uniformly support such an approach. Rather, the courts and the CFTC (as well as its predecessor agency) in those cases have conducted a more searching review to determine price artificiality. And, notably, none of those cases – including *In re DiPlacido* – deem economic analyses (e.g. historical and contemporaneous price comparisons) irrelevant to an artificiality determination.[7]

In re Eisler and First West Trading, Inc., for example, is cited by the Commission as a case where "distorted prices foreseeably follow from the device employed by the manipulator" so that "detailed economic analysis of effect on price" is not required. *See* 75 Fed. Reg. at 67661. Yet, the CFTC in *Eisler did* perform a relatively detailed economic analysis to figure out whether the settlement prices at issue were artificial. More specifically, the CFTC compared the settlement-price volatilities of P-Tech options during the period in question with: i) the settlement-price volatilities of those options in different months, ii) the historical volatilities for the P-Tech futures contract, and iii) the closing trade-price volatilities from options on two other technology-based stock indices. [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,664 at , 2004 WL 77924 (CFTC Jan. 20, 2004). Finding that there was "no rational market-based explanation" for the significant deviations of the settlement-price volatilities of the P-Tech options from the other economic data, the CFTC concluded that "the settlement prices of the P-Tech option contract, during the period analyzed were artificial." *Id.*

Similarly, in *In re Henner*, the CFTC's predecessor agency considered relevant economic data in addition to the conduct of the accused when assessing whether the November 1968 shell egg futures price on June 25 was artificial. 30 Agric. Dec. 1151 (1971). The agency's review of the October-November and November-December price spreads on June 25 and the point range in the closing price for the November contract was actually quite thorough, spanning approximately thirteen pages of the opinion. *Id.* at 1208-1220. Ultimately, the agency determined that such price analyses offered "other convincing proof" of price artificiality. *Id.* at 1208. The Commission's proposal fails to acknowledge that its predecessor agency undertook this comprehensive review of price artificiality in *Henner* rather than rely solely on the defendant's conduct.

Though *In re Indiana Farm Bureau Cooperative Association, Inc.* – from which the Commission's proposal takes a quote that it incorrectly attributes to *In re Hohenberg Bros.*[8] – states that the "focus [in demonstrating price artificiality] should not be *as much* on the ultimate price," it still supports undertaking a thorough price artificiality analysis. [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796 at (CFTC Dec. 17, 1982) (emphasis added). In that case, the CFTC looked to "the nature of the *factors* causing [the ultimate price]," not just proof of the actions of the alleged manipulator. *Id.* (emphasis added). After examining the relevant market factors – i.e. tight corn supply, the defendant's standing for delivery, and the panic bidding of shorts – the CFTC determined that the price rise in the July 1973 corn futures contract was "reflective of the legitimate forces of supply and demand" and therefore not artificial. *Id.* A few years later, in *In re Cox,* the CFTC clarified that a price artificiality analysis should take into account the types of market factors considered in *Indiana Farm Bureau* as well

[7] In *In re DiPlacido*, the CFTC observed that manipulation case law has looked at the following factors to determine whether prices are "artificial": "relationship between an allegedly artificial price and historic trends, the relationship between cash market prices and futures prices, etc." The CFTC went on to note that such factors are more relevant "in the context of traditional corners and squeezes" than in manipulation situations not involving market power. 2008 WL 4831204 (CFTC 2008), *aff'd in pertinent part, DiPlacido v. Commodity Futures Trading Comm'n*, Fed.Appx. 2009 WL 3326624 (2d Cir. 2009), at *30.

[8] *See* 75 Fed. Reg. at 67661.

as historical and contemporaneous price data because "all [such] considerations are relevant to determining price artificiality, [with] the weight to be given these factors var[ying] according to the circumstances of each case." [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786 at (CFTC July 15, 1987).

CME Group recommends that the Commission adopt the approach to determining price artificiality outlined in *Cox*, weighing all relevant factors according to the specific facts of a given case, rather than relying solely on inferences from an accused's actions. This more comprehensive review is not only consistent with the precedent cited in the Commission's proposal, but also maintains the integrity of the traditional four-part test. Indeed, if the Commission adopts a "we-know-it-when-we-see-it-approach," it will essentially be collapsing the third and fourth element of the traditional framework – that is, when the Commission sees certain conduct after the fact that it finds to raise some kind of "red flag," it can automatically conclude that such conduct *resulted* in *artificial* prices.

Moreover, the Commission's proposed "conclusive presumption" based on conduct alone – and the attendant watered-down manipulation test – would apply "often" according to the NOPR, leaving the traditional four-factor test to govern in an undefined universe of remaining cases. The potential applicability of two price manipulation frameworks (one of which relies solely on the nature of a defendant's conduct to satisfy artificiality and causation) will create uncertainty for market participants and may chill legitimate market behavior to the detriment of the liquidity and depth of CFTC-regulated markets. To avoid these unintended consequences, CME Group urges the Commission in any given case to undertake a comprehensive review of all considerations relevant to price artificiality.

III. CONCLUSION

CME Group supports the Commission's long standing efforts to police price manipulation and its attempts to implement its new statutory authority to prohibit conduct that constitutes a "manipulative or deceptive act or practice." No matter how well meaning, the Commission's proposals would be counter-productive in many ways if the final rules stated prohibitions that fail to afford market participants adequate and unambiguous notice of the kind of conduct the Commission would find to be prohibited. We urge the Commission to re-double its efforts to provide greater clarity to market participants. Given our mutual and shared interest in market integrity, CME Group would be pleased to work with the Commission to help to perfect its proposals in this area, at the Commission's request.

CME Group thanks the Commission for the opportunity to comment on this matter. We would be happy to discuss any of these issues with Commission staff. If you have any comments or questions, please feel free to contact me at (312) 930-8275 or via email at **Craig.Donohue@cmegroup.com**, or Christal Lint, Director, Associate General Counsel, at (312) 930-4527 or **Christal.Lint@cmegroup.com**.

Sincerely,

Craig S. Donohue

Craig S. Donohue

cc: Chairman Gary Gensler
Commissioner Michael Dunn
Commissioner Bart Chilton
Commissioner Jill Sommers
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