**UNITED STATES OF AMERICA**
**BEFORE THE**
**FEDERAL ENERGY REGULATORY COMMISSION**

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| Prohibition of Energy Market Manipulation | Docket No. RM06-3-000 |

## COMMENTS OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

The International Swaps and Derivatives Association, Inc. ("ISDA") hereby submits these comments in response to the Federal Energy Regulatory Commission's (the "Commission") Notice of Proposed Rulemaking on the Prohibition of Energy Market Manipulation published on October 27, 2005 (the "NOPR").[1]

ISDA supports the Commission's intent to provide greater certainty to market participants by implementing Sections 315 and 1283 of the Energy Policy Act of 2005 ("EPAct of 2005") prohibiting manipulative or deceptive practices in the wholesale electric energy and gas markets.[2] ISDA is concerned, however, that the mechanism the Commission has chosen to implement Congress' mandate – a rule based on SEC Rule 10b-5[3] – will not provide market participants with sufficient notice of what conduct is prohibited by the rule. ISDA respectfully requests that, before adopting final regulations, the Commission carefully consider the likely impact of adopting the proposed regulation and relying upon the full panoply of SEC Rule 10b-5 precedent as proposed in the NOPR.

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[1] *Prohibition of Energy Market Manipulation*, 70 Fed. Reg. 61,930 (Oct. 27, 2005).

[2] Energy Policy Act of 2005, Pub. L. 109-58, 119 Stat. 594 (2005).

[3] 17 C.F.R. § 240.10b-5.

## I. BACKGROUND

ISDA is the global trade association representing participants in the privately negotiated derivatives industry, a business covering swaps and options across all asset classes (including interest rate, currency, commodity and energy, credit and equity). ISDA was chartered in 1985, and today numbers over 670 member institutions from 47 countries on six continents. These members include most of the world's major institutions who deal in, as well as leading end-users of, privately negotiated derivatives. Many ISDA members or their affiliates are power marketers authorized by the Commission to sell wholesale electricity at market-based rates. These same members purchase and sell gas and electricity in the wholesale market, and trade derivatives contracts based upon notional quantities of gas, electricity and other energy commodities. In recent years, ISDA, with the support and participation of its members, has promulgated several initiatives to incorporate annexes to its existing and widely-accepted master agreement to allow for the trading of physical gas, power and emissions allowances.

ISDA has led efforts to identify and reduce the sources of risk in the derivatives and risk management businesses. These efforts have included developing the ISDA master agreement and related physical-product annexes, publishing a wide range of documentation materials and instruments for a variety of transaction types, analyzing and producing opinions on collateral arrangements, promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from the public policy and regulatory capital perspectives.

## II. COMMENTS

Competitive and liquid wholesale energy trading markets are important to the United States economy and to the risk management activities of energy market participants. The Commission has emphasized that its proposed regulations are intended to benefit the energy

markets by providing certainty as to what conduct is prohibited.[4] The proposed regulations are intended to implement language from the EPAct of 2005 prohibiting the use of "manipulative or deceptive devices or contrivances" in connection with the purchase or sale of electric energy or gas and transmission or transportation services subject to the Commission's jurisdiction.[5] This language is based on Section 10(b)of the Securities Exchange Act of 1934.

The Securities and Exchange Commission implemented Section 10(b)by adopting, *inter alia*, Rule 10b-5, which makes it unlawful for a person to:

(a) employ any device, scheme, or artifice to defraud,

(b) make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.[6]

In the NOPR, the Commission proposed regulations based on Rule 10b-5 and stated its intent to rely on "the large body of case law interpreting and applying section 10(b) and Rule 10b-5 when applying" the proposed regulations.[7]

ISDA believes that the rules governing conduct in the wholesale energy markets should be clear to market participants. The Commission should ensure that the rules it promulgates are specifically tailored to wholesale energy markets and the participants to which they will apply. Moreover, ISDA assumes that the Commission does not intend to impose duties from other markets or industries that are not comparable to the wholesale commodities markets. The duties

[4] NOPR at P 14.

[5] *See* EPAct 2005 §§ 315, 1283.

[6] *See* 17 C.F.R. § 240.10b-5.

[7] NOPR at P 14.

which arise under the securities laws are substantially different from those that apply to cash market energy and other commodity transactions.[8]

Because of the substantial differences in the functions of and participants in these markets, and the regulatory regimes that govern them, the Commission should not adopt the large body of Rule 10b-5 case law. Such action will create substantial uncertainty concerning the obligations and standards applicable to participants in the wholesale commodity markets. Indeed, the EPAct of 2005 does not mandate the adoption of Rule 10b-5 and all of the precedent interpreting that provision. Absent such a requirement in the statute, it is fair to assume that Congress did not intend the Commission to adopt inapposite case law developed under a different regulatory regime. ISDA, therefore, strongly encourages the Commission not to adopt any of the SEC precedent under Rule 10b-5 in this rulemaking without first considering very carefully the implications of such a significant policy decision.[9]

ISDA also is concerned about the Commission's proposal to adopt almost verbatim the language of Rule 10b-5 and, in particular, about the implications of applying to the wholesale energy markets the second prong of the rule governing misstatements or omissions of material facts. Rule 10b-5 functions as part of a system of disclosure focused primarily on issuer-specific information; it is designed to ensure that all market participants have equal access to information when deciding whether to invest in a particular company. Participants in the wholesale electric energy and gas markets do not rely on analogous issuer-specific information when deciding whether to transact; in fact, it is difficult to identify who or what in the electric energy and gas

[8] In the NOPR, the Commission referenced the Commodity Futures Trading Commission's general anti-fraud rule. NOPR at P 13. ISDA notes that the regulatory regime applicable to the futures markets also differs substantially from that applicable to the securities and over-the-counter energy markets.

[9] In addition, the EPAct of 2005 does not contain a specific deadline by which the Commission must promulgate regulations. The Commission, therefore, has the discretion to take the necessary time to consider the appropriateness of application of the several components of Rule 10b-5 and the extensive case law thereunder.

markets would function as the "issuer" – a construct integral to the jurisprudence and precedent surrounding Rule 10b-5.

Furthermore, relationships between securities market participants and energy market participants are very different and the standards applicable to the former cannot be applied to the latter. Rule 10b-5 primarily was structured to address relationships between brokers and customers or between corporate insiders and other market participants. No analogous relationships exist in the energy markets. Given these fundamental differences between the securities markets and the wholesale commodities markets, and the different obligations under the respective statutes, adopting a rule based upon Rule 10b-5 and all of the related precedent will create unnecessary confusion and uncertainty in the energy markets.

### A. SEC Rule 10b-5 is Designed for Different Markets Than the Proposed FPA/NGA Market Manipulation Provisions

The securities laws are designed to protect the public who may purchase or sell securities. This regulatory regime includes expansive disclosure provisions, including detailed standards regarding the information that a corporation must disclose to current holders and potential purchasers and sellers of the corporation's securities. The disclosure requirements and various additional regulatory mandates are intended to ensure that potential investors have equal access to issuer-specific information when deciding whether to invest in a company.

By contrast, the overarching purpose of both the FPA and NGA is to ensure that the rates and other terms and conditions of service are "just and reasonable."[10] Under the market-based rate regime governing wholesale electricity and natural gas markets, the market rules are designed to ensure vigorous price competition which, in turn, will result in just and reasonable

[10] *See, e.g.*, 16 U.S.C. § 824d.

rates.[11] ISDA notes that Congress' decision to omit a private right of action from the market manipulation provisions of the EPAct of 2005 is consistent with this focus on ensuring market integrity. Another distinguishing characteristic of these markets is that wholesale purchase and sales transactions are conducted at arm's length between sophisticated commercial parties. While ISDA recognizes that accurate disclosure to the Commission and market operators, as well as rules regarding fraud and manipulation, are important components of this regime, there is no evidence that a comparable benefit would result from application of the securities law disclosure mandate, which is primarily issuer-specific. Disclosure principles utilized in the securities markets are not designed to ensure just and reasonable rates in wholesale commodities markets. The Commission's regulations, and any SEC precedent it intends to use when interpreting those regulations, must reflect these distinctions.

### B. The Commission Should Recognize the Inapplicability of the SEC's Disclosure Provisions

The second prong of Rule 10b-5 prohibits making an untrue statement of material fact, or omitting a material fact, in an effort to mislead.[12] ISDA is particularly concerned with the Commission's proposed adoption of this prong of Rule 10b-5 and the related precedent. Borrowing precedent related to these securities market requirements will not provide sufficient notice to wholesale energy market participants about what types of conduct are prohibited.

ISDA is confident that the Commission does not intend to create uncertainty about well settled principles that govern practices in wholesale commodities markets. ISDA believes that to

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[11] *See, e.g., Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 FERC ¶ 61,218 at P 3 (2003) ("Market Behavior Rules . . . will help ensure that rates are the product of competitive forces and thus remain just and reasonable."); *see also Elizabethtown Gas Co. v. FERC*, 10 F.3d 866,870 (D.C. Cir. 1993) (stating that FERC may rely on a competitive market to assure prices are just and reasonable.); *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1004 (D.C. Cir. 1990).

[12] 17 C.F.R. § 240.10b-5.

be the case because importing legal standards from a wholly separate market could frustrate the ability of marketers and dealers to hedge the price and other risks associated with their wholesale trading transactions.[13] In 1984, the Commodity Futures Trading Commission, based upon an extensive study of the nature, extent and effects of futures trading by persons possessing material, non-public information, observed that

> [t]he 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.[14]

Applying such a standard here would adversely affect the risk shifting function of wholesale electricity and gas transactions.

Similarly, the Commission would not want to confuse market participants regarding the application of a broad material omission standard to price reporting, where there is no duty to report in the first instance. Imposing an undefined disclosure obligation would be inconsistent with the Commission's stated policy of encouraging voluntary price reporting.

A substantial body of SEC and federal court case law examines the various duties of disclosure created under the broad range of securities laws. Under Section 10(b)of the 1934 Act and Rule 10b-5, the duty to disclose can arise because a statute or regulation requires it, there is a need to correct an earlier statement, when an insider trades on non-public corporate information, or where a fiduciary relationship exists between the parties.[15] Fundamentally, these duties flow

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[13] *See e.g.,* Commodity Futures Trading Commission, *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information*, Submitted to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition and Forestry of the Senate, at 8 (Sept. 1984).

[14] *Id.*

[15] 1 FEDERAL SECURITIES EXCHANGE ACT OF 1934 § 5.04[1], at 5-30 (2005) (A. A. Sommer, Jr., ed., 2005) (citing *Chiarella v. U.S.*, 445 U.S. 222, 235 (1980); *SEC v. Texas Gulf Sulphur*, 401 F.2d 883, 860-61 (2d Cir. 1968);

(continued...)

from relationships that exist in the securities market and arise outside the context of Rule 10b-5, such as between broker and client, advisor and client or a corporate insider and its corporation or other market participants. It is the nature of these relationships that gives rise to duties to disclose and, in the absence of these types of relationships and the duties that flow from them, it is not clear how or if Rule 10b-5 principles can apply. These types of relationships simply do not exist in the wholesale energy commodity markets, nor can they be created without substantial changes to the structure of these markets and, as a result, the duties that trigger Rule 10b-5 liability do not exist. Accordingly, the disclosure obligations under Rule 10b-5 cannot be replicated in the wholesale energy commodities markets.

The Commission's disclosure requirements are appropriately far more limited. Entities authorized to transact at market-based rates are required to report accurate information to the Commission (such as EQRs) and must communicate accurate information to ISOs/RTOs, market monitors and jurisdictional transmission operators under the Market Behavior Rules.[16]

The Commission should be quite wary of adopting the SEC's rule and precedent without substantially limiting their application to the wholesale energy commodities markets. By carefully drafting the proposed rule in the context of the markets in which it will apply, the Commission also would avoid being placed in the unintended and untenable position of receiving constant entreaties from parties to address disputes between market participants that are unrelated to the Commission's mandate to ensure vigorous and fair competition in the wholesale electric and gas markets.

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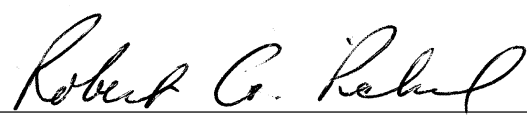
*Roeder v. Alpha Indus., Inc.*, 814 F.2d 222, 226-27 (1st Cir. 1987); 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3517 (3d Ed. 1992)).

[16] *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 FERC ¶ 61,218 at P 136 (adopting Market Behavior Rule #3 requiring truthful disclosures).

## III. CONCLUSION

Although the Commission's stated goal is to provide market participants with certainty about how it will interpret and apply the new market manipulation provisions of the EPAct of 2005, the NOPR will not achieve that result. Instead, relying on Rule 10b-5 and the related SEC enforcement precedent will create uncertainty and confusion among market participants.

Respectfully submitted,



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