



November 10, 2022

Ms. Kimberly Bose  
Secretary  
Federal Energy Regulatory Commission  
888 First Street, NE  
Washington, DC 20426

**Re: Notice of Proposed Rulemaking on Duty of Candor in Docket No. RM22-20-000**

Dear Ms. Bose:

The Futures Industry Association (“FIA”)<sup>1</sup> appreciates this opportunity to comment on the Federal Energy Regulatory Commission’s (“FERC” or “Commission”) Notice of Proposed Rulemaking on Duty of Candor (“NOPR”)<sup>2</sup> issued in Docket No. RM22-20-000. As a general matter, FIA and its members fully support accurate and truthful communications with federal regulators, including FERC. We write to highlight several features of the NOPR, in its formulation of a duty of candor, that may have unintended negative consequences for our members that are active in physical derivatives markets regulated by the Commodity Futures Trading Commission (“CFTC”) as well as the wholesale power and gas markets regulated by FERC. Although we have no doubt the NOPR is well-intentioned, our concerns with the current text of the NOPR are fundamental. It is important that FERC carefully assess the scope of the rule, which would dramatically expand the scope of entities and communications potentially subject to FERC rules. If FERC takes the extraordinary step to apply the rules as broadly as prescribed in the NOPR, it is critical that FERC (i) include a scienter element for intentional or willful misconduct in place of the due diligence standard and (ii) include a well-defined materiality element to differentiate between inadvertent errors or omissions and material issues.

We explain our position in detail below. In brief, principles of truthfulness lie at the heart of any duty of candor, as does the element of scienter, *i.e.*, a culpable state of mind. Under traditional Federal jurisprudence, inaccurate statements or omissions require a culpable state of mind to rise to the level of a crime or civil violation subject to penalty. While FIA understands the Commission’s desire to establish a duty of candor, any such duty must include the element of scienter and provide a clear materiality standard to operate as effective limiting principles to the exercise of Commission jurisdiction. These features allow regulated entities to focus their compliance resources on preventing

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<sup>1</sup> FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. Our membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. FIA’s mission is to support open, transparent, and competitive markets, to protect and enhance the integrity of the financial system, and to promote high standards of professional conduct.

<sup>2</sup> *Duty of Candor*, 180 FERC ¶ 61,052 (2022) (published in the Federal Register at 87 Fed. Reg. 49784 (Aug. 12, 2022)) (“NOPR”).

illegitimate, deceptive communications rather than diverting resources to document any and all communications with FERC or other third parties relating to FERC-jurisdictional matters.

The proposal to require persons and entities to perform “due diligence to prevent such occurrences”<sup>3</sup> turns traditional jurisprudence on its head by shifting the burden of proof upon the regulated community. FIA is concerned that the duty of candor as proposed would lead to unpredictable enforcement activity upon a broad spectrum of persons and entities. Of particular interest to FIA, the rule could hinder legitimate, in some cases critical day-to-day, communications and activities of a number of FIA constituent members, including but not limited to, derivatives exchanges, derivatives clearinghouses, derivatives clearing members and brokers, and producers, processors, and end users of physical commodities.

Striking the due diligence requirement in favor of a scienter element and well-defined materiality standard would make compliance with the duty of candor far more practical for the broad spectrum of regulated entities that could become subject to the rule. We urge FERC to implement these limiting principles if it moves forward with the rule.

#### **I. A Final Rule Should Include The Elements Of Scienter And Materiality As Proper Limiting Principles**

FIA respectfully requests that the Commission revise its proposed rule to include a scienter element for intentional or willful misconduct and strike the due diligence requirement. Throughout the Federal system, duty of candor standards include both scienter and materiality elements. As we read the NOPR, it would allow FERC to prosecute market participants without having to prove either element. This is a marked departure from the weight of FERC’s own precedent and candor provisions developed and enforced by other federal agencies. More fundamentally, we believe it is neither fair nor necessary for FERC to adopt a duty of candor that, in effect, imposes a strict liability standard on market participants.

The NOPR is largely based on existing FERC regulation 18 C.F.R. § 35.41(b), which prohibits inaccurate communications by Sellers with market-based rate authority to FERC, regional transmission organizations (“RTOs”), independent system operators (“ISOs”), market monitors and jurisdictional transmission providers.<sup>4</sup> While the existing FERC duty of candor has been held in Federal Court as not requiring an intent element for Sellers making false statements or omitting material facts in relevant communications,<sup>5</sup> this standard is applied to a far narrower set of FERC-

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<sup>3</sup> NOPR at P. 24.

<sup>4</sup> 18 C.F.R. § 35.41 (b) (stating that “[a] Seller must provide accurate and factual information and not submit false or misleading information, or omit material information, in any communication with the Commission, Commission-approved market monitors, Commission-approved regional transmission organizations, Commission-approved independent system operators, or jurisdictional transmission providers, unless Seller exercises due diligence to prevent such occurrences.”).

<sup>5</sup> See NOPR at P 18 (citing *Kourouma v. FERC*, 723 F.3d 274, 278-79 (D.C. Cir. 2013); see also NOPR at n. 37.

jurisdictional Sellers who operate as public utilities under the Federal Power Act.<sup>6</sup> We do not see this as a legal precedent, much less a policy justification, for extending a duty of candor lacking a scienter and clearly defined materiality elements as far as the NOPR could extend.<sup>7</sup>

We believe the better guidepost is FERC's promulgation of the Market Behavior Rules in 2003. Those rules included the Market Behavior Rule 3, which is now 18 C.F.R. § 35.41(b).<sup>8</sup> In response to comments arguing that the proposed rule should only prohibit violations "knowingly committed," FERC determined in part that:

We have also revised the rule to assure that *inadvertent submission of inaccurate or incomplete information will not be sanctioned*. As revised, *the rule prohibits the knowing submission of false or misleading data*.<sup>9</sup>

On rehearing, FERC Commissioner Nora Mead Brownell clarified in a concurrence that: "As the order notes, intent is a necessary element of any violation of Market Behavior Rule 2(b), 2(c), or 3 (now Section 35.41(b)). Moreover, it is the seller's intent that ultimately concerns us under these Rules, rather than the intent of individual staff."<sup>10</sup>

Given the NOPR's broad application to "any entity," it is incumbent upon FERC to incorporate scienter and materiality limiting principles when establishing a duty of candor.

We encourage FERC to look to the examples of other federal agencies that have recently established broadly applicable candor rules. The United States Patent and Trade Office ("USPTO") provides a model for imposing a duty of candor and good faith on all individuals associated with the filing and prosecution of patent applications before the USPTO.<sup>11</sup> Subject individuals must disclose all information *known* to the individuals to be *material* to patentability.<sup>12</sup> The USPTO defines materiality within its regulations, which provides clarity for compliance.<sup>13</sup> FERC should consider adopting similar standards here.

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<sup>6</sup> 16 U.S.C. § 824

<sup>7</sup> NOPR, Commissioner Danly dissenting at fn. 6 (stating that while it may be "reasonable to put the onus on sellers ... [t]he Commission cannot, therefore, assume a similar result should this rule, as broadly drafted as it is, be reviewed in the courts.") FIA does not take a view at this time with respect to the existing FERC regulation at 18 C.F.R. § 35.41(b).

<sup>8</sup> See *Investigation of Terms and Conditions of Pub. Util. Market-Based Rate Authorizations*, 105 FERC ¶ 61,218 (2003).

<sup>9</sup> *Id.* at P 110 (emphasis added) (internal footnotes omitted).

<sup>10</sup> See *Investigation of Terms and Conditions of Pub. Util. Market-Based Rate Authorizations*, 107 FERC ¶ 61,175, at 61,725-26 (2004) (Brownell, Comm'r, concurring).

<sup>11</sup> See 37 C.F.R. § 1.56(a).

<sup>12</sup> *Id.*

<sup>13</sup> See 37 C.F.R. § 1.56 (b) (stating that "information is material to patentability when it is not cumulative to information already of record or being made of record in the application, and (1) It establishes, by itself or in combination with other information, a prima facie case of unpatentability of a claim; or (2) It refutes, or is inconsistent with, a position the applicant takes in: (i) Opposing an argument of unpatentability relied on by the Office, or (ii) Asserting an argument of patentability."

Scienter and materiality elements feature prominently within the jurisprudence governing Section 10(b) of the Securities and Exchange Act of 1934 and the Securities Exchange Commission's ("SEC") anti-manipulation rule which applies "only to intentional wrongdoing"<sup>14</sup> for making "any untrue statement of material fact or omit[ting] to state a material fact necessary to make the statements made ... not misleading ...."<sup>15</sup> Indeed, when Congress enacted EAct2005, the statute specifically stated that the anti-manipulation sections amending the Natural Gas Act and Federal Power Act, respectively, closely tracked the prohibited conduct language in section 10(b) of the Securities Exchange Act of 1934.<sup>16</sup> In implementing the anti-manipulation sections of EAct 2005, the Commission stated in Order 670 that:

[c]onsistent with the mandate that certain aspects of the Commission's new authority be exercised in a manner consistent with section 10(b) of the Exchange Act, consistent with Congress' modeling sections 315 and 1283 of the EAct 2005 on section 10(b) of the Exchange Act ... the Commission has modeled the Final Rule on Rule 10b-5.<sup>17</sup>

The Commission further stated in Order No. 670 that this approach "will benefit entities subject to the new rule because there is a substantial body of precedent applying the comparable language of Rule 10b-5" of which scienter and materiality play elemental roles.<sup>18</sup>

Similarly, when establishing its anti-manipulation rule under the Dodd-Frank Act, the CFTC explained the necessity of the scienter element in prohibiting any person from *intentionally* or *recklessly* making a false or misleading statement of material fact or omitting a material fact.<sup>19</sup> The CFTC explained that the scienter requirement allows the CFTC to ensure that negligence and good-faith mistakes will not constitute violations for false and misleading statements, nor material omissions.<sup>20</sup> "Thus, a person lacking the requisite scienter cannot be found to have engaged in a manipulative or deceptive device or contrivance."<sup>21</sup> The same should be said for violations of any FERC proposed duty of candor. Absent the requisite showing of an untruthful state of mind, an entity should not be found to have engaged in duty of candor violations, particularly for good-faith mistakes or simple negligence.<sup>22</sup>

Scienter and materiality standards are also critical components of professional rules of conduct, which are relevant here because the NOPR would apply to non-employee agents, and thus legal and other

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<sup>14</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 187 (1976); see also, *Aaron v. SEC*, 446 U.S. 680, 690 (1980).

<sup>15</sup> See 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5.

<sup>16</sup> See 15 U.S.C. § 717c-1 (2005); 16 U.S.C. § 824v(a) (2005).

<sup>17</sup> Order No. 670, *Prohibition of Energy Market Manipulation*, 114 FERC ¶ 61,047, at P. 7 (2006)

<sup>18</sup> *Id.*

<sup>19</sup> *Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation*, 76 Fed. Reg. 41398, 41404 (July 14, 2011); see 17 C.F.R. § 180.1.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* (citing *Drexel Burnham Lambert Inc. v. CFTC*, 850 F.2d 742, 748 (DC Cir. 1988) (noting that a showing of *recklessness*, at the minimum, is required in order to prove scienter, and defining recklessness, in accordance with long-standing commodities and securities laws, as an omission or act that "departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing.")).

professional representatives, of in-scope entities. FERC's Rules of Practice and Procedure provide that all filings must be signed with a signature attesting that the contents of the filing are true to the best of the signer's *knowledge* and belief.<sup>23</sup> Similarly, the USPTO also imposes a duty of candor on practitioners that prohibits the practitioner from *knowingly* making false statements of facts to tribunals or failing to correct a statement of fact that the practitioner previously made to the tribunal and offering evidence that the practitioner *knows* to be false.<sup>24</sup> Further, when a practitioner represents a client in a proceeding before a court and *knows* of a person's intent to engage in criminal or fraudulent conduct related to the proceeding, the practitioner must take appropriate remedial action, including, if necessary disclosing such knowledge to a tribunal.<sup>25</sup> As FERC recognized in the NOPR, the American Bar Association's Model Rules of Professional Conduct ("ABA Model Rules") provides that "a lawyer shall not *knowingly* make a false statement of fact or law to a tribunal or fail to correct a false statement of *material* fact or law previously made to the tribunal by the lawyer."<sup>26</sup> FERC also acknowledged that numerous state bar rules of professional conduct are also based upon the ABA Model Rules.<sup>27</sup> Notably, each of these rules incorporate scienter and materiality elements, even those established by FERC. Any proposed duty of candor should do the same, as a matter of law and policy.

## **II. The NOPR Imposes A Due Diligence Burden Upon A Broad Spectrum Of Entities And Day-to-Day Operations**

The NOPR takes the existing regulation applicable only to FERC-jurisdictional Sellers and attempts to broaden it to include *all* entities communicating with FERC or other specified entities related to matters subject to FERC's jurisdiction. As defined in the NOPR, the term "entity" would encompass both organizations and individuals and would apply to those responsible for the relevant communications, including non-agent employees.<sup>28</sup> Further, an entity that exercises due diligence to ensure the accuracy of its communications will have the burden of an affirmative defense to any alleged violation of the regulation in order to avoid penalties or sanctions in the event of inaccurate statements.<sup>29</sup> FERC will analyze an entity's due diligence efforts by reviewing all relevant facts related to determining whether an entity took reasonable steps to ensure the accuracy and completeness of a communication in light of the totality of the circumstances.<sup>30</sup>

Unfortunately, it is not clear under the proposal what level of due diligence would be considered sufficient for an entity to mitigate or avoid a violation and to what extent a particular communication would be considered material. And, the practical reality is that by placing the burden on market participants to justify any and all communications, FERC is imposing on those entities substantial additional costs by way of new policies and procedures, documentation and monitoring of outbound

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<sup>23</sup> NOPR at P 9 (emphasis added).

<sup>24</sup> See 37 C.F.R. § 11.303(a) (emphasis added).

<sup>25</sup> See *Id.* § 11.303(b) (emphasis added).

<sup>26</sup> NOPR at P 12 (emphasis added) (citing Am. Bar Assoc. Model Rules of Prof'l Conduct R. 3.3(a)(1)).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at P 40.

<sup>29</sup> See *id.* PP 28 and 43.

<sup>30</sup> *Id.* at P 43.

communications. Further, the NOPR does not make it clear what the consequent penalties would be for duty of candor violations.

We expect FERC will hear from a range of industry representatives on the challenges posed by the NOPR to particular segments of the energy industry. We hope to make clear with this letter that the challenges extend beyond market participants who are accustomed to being directly regulated by FERC. As proposed, FIA is concerned that the following situations involving FIA members which are active in physical derivatives markets – namely, Designated Contract Markets, Derivatives Clearing Organizations, Futures Commission Merchants, Swap Dealers, and certain producers, processors and end-users, as well as their legal counsel – could be harmed by the heightened compliance costs associated with the due diligence requirements.

**A. Designated Contract Markets and Derivatives Clearing Organizations Could Be Subject To The Duty Of Candor Due Diligence Burden For Communications With FERC Jurisdictional Facilities**

Designated Contract Markets (“DCMs”) and Derivatives Clearing Organizations (“DCOs”) – *i.e.*, futures exchanges<sup>31</sup> and clearinghouses<sup>32</sup> governed by the Commodity Exchange Act – often engage in discussions with oil and natural gas pipelines, storage entities, and RTOs and ISOs in developing, administering, and clearing derivatives contracts. Futures contracts include key physical energy delivery mechanisms and financial settlements on FERC jurisdictional facilities, including but not limited to pipeline, storage, and transmission facilities for:

- Crude Oil at Cushing, OK
- Reformulated Blendstock for Oxygenate Blending (RBOB) Gasoline in the New York Harbor
- Ultralow Sulphur Diesel in the New York Harbor
- Natural Gas in the Henry Hub region of Louisiana and
- Electric Energy for PJM Interconnection West Hub.

Under the NOPR, DCMs and DCOs could be subject to the duty of candor regarding any communications with these and other FERC-jurisdictional facilities. We question whether FERC has the statutory authority and intended for DCMs and DCOs to be subject to the duty of candor. However, as it is written, futures exchanges may be in scope. FIA is concerned that finalization of the NOPR in its current form would discourage critical communications between the DCMs and DCOs and FERC jurisdictional facilities, leading to inefficiencies and a potential lack of needed transparency. Also, absent the statutory authority, the NOPR could attempt to require DCMs and DCOs to incur significant compliance obligations for communications with pipelines and RTOs and ISOs, in addition to the compliance obligations to which they are already subject under the CEA and related CFTC regulations. If FERC is to apply the duty of candor so broadly as to potentially encompass customary activities of

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<sup>31</sup> See 7 USC § 7.

<sup>32</sup> See 7 USC § 7a-1.

futures exchanges, scienter and materiality elements are critical to avoid chilling legitimate communications and imposing substantial compliance costs on CFTC-regulated entities without offsetting benefits.

**B. Futures Commission Merchants and Swap Dealers Could Be Subject To The Duty Of Candor Due Diligence Burden For Communications With FERC Jurisdictional Pipelines And Storage Facilities**

The NOPR may likewise subject Futures Commission Merchants (“FCMs”) and Swap Dealers to unnecessary and burdensome compliance requirements.

FCMs are entities that provide clearing and execution services for customers that trade derivatives on global exchanges and over-the-counter (“OTC”) markets.<sup>33</sup> Among other activities, FCMs play a key role in coordinating physical deliveries on FERC-jurisdictional facilities when market participants physically settle futures contracts. In some instances, FCMs and DCMs will be engaged in real-time discussions with the FERC-jurisdictional facilities to discern delivery issues, particularly issues around late delivery or force majeure.

Swap Dealers are entities that provide swap liquidity by making markets for swaps,<sup>34</sup> particularly to commercial market participants like utilities seeking to hedge power and natural gas exposures. Swap dealers communicate with FERC-jurisdictional facilities to execute swap transactions for the purposes of hedging, and such communications involve a comprehensive suite of regulations meant to protect non-swap dealing parties, including pre-trade disclosures of material economic terms, material risks, know your counterparty (“KYC”), among other things.<sup>35</sup>

Again, we question whether FERC has the statutory authority and whether it intended to impose a duty of candor on FCMs and Swap Dealers in their respective discussions with FERC-jurisdictional facilities. The duty of candor rule, as proposed, could act to chill critical FCM communications during futures delivery settlements, or Swap Dealer communications regarding variation margin calculations. Like DCMs, FCMs and Swap Dealers are already subject to comprehensive regulation as CFTC registrants. At a minimum, FERC should adopt scienter and materiality elements to avoid the potential negative consequences of a broadly applicable rule.

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<sup>33</sup> The Commodity Exchange Act (“CEA”) defines FCM as “an individual, association, partnership, corporation, or trust that is engaged in soliciting or in accepting orders for [certain CFTC-jurisdictional products]... and in or in connection with [such activity], accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.” 7 U.S.C.1a (28).

<sup>34</sup> See 7 U.S.C. § 1a(49); see further, *Further Definition of Swap Dealer et al.*, 77 Fed. Reg. 30,596 (May 23, 2012).

<sup>35</sup> See *Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties*, 77 Fed. Reg. 9,734 (Feb. 17, 2012).

### **C. Day-To-Day Communications With FERC Jurisdictional Facilities By Producers, Processors, And End-Users Could Be Subject To Due Diligence Burden Of The Duty Of Candor**

As with DCMs and FCMs, the producers, processors, and end-users of physical commodities could have their day-to-day communications with FERC jurisdictional facilities subject to the proposed duty of candor requirement. Such day-to-day communications include, but are not limited to, operational and scheduling discussions, competitive, arm's length bi-lateral transactional discussions, effectuations of Exchange for Physical transactions,<sup>36</sup> and declarations of force majeure. The NOPR leaves many important questions unresolved regarding its application to such daily communications. For instance, it is unclear what would need to be disclosed in operational and scheduling discussions. It is also unclear what would constitute appropriate confidential information that would not have to be disclosed in an arm's length negotiation with a FERC-jurisdictional oil or natural gas pipeline, which is to say, what may constitute a material omission of information under the rule. Similarly, it is unclear to what extent a party would be required to immediately explain the reasons for a force majeure in discussions with a pipeline counterparty. Further, it is not clear what level of due diligence producers, processors, and end users must show to be found not to have violated the rule notwithstanding an inaccurate statement.

If the NOPR becomes a final rule, the combinations and permutations of enforcement risk surrounding valid communications would increase dramatically compared to the current regulatory environment. This is particularly at issue with respect to communications with oil and natural gas pipelines. Absent inclusion of scienter and materiality elements in place of the due diligence standard, commercial market participants would likely curtail critical communications with FERC-jurisdictional facilities in order to avoid potential violations.

### **D. The NOPR Presents Unique Challenges For Attorney-Client Communications**

The proposed duty of candor also presents unique challenges for legal counsel of any entity subject to the NOPR, and thus its due diligence burden. The NOPR makes clear that a non-employee agent of an entity involved in the submission of a communication would be subject to the proposed regulation.<sup>37</sup> The NOPR further provides that the entity and its counsel should both exercise due diligence to ensure accuracy of submitted communications, and that while the entity will bear the greater burden of ensuring the communication's accuracy, counsel would likely be required to ensure that it has no reason to believe that the submitted communication is false.<sup>38</sup> FIA believes that the application of the proposed rule to counsel could impair its members' access to effective counsel. The due diligence requirement, as applied to counsel, could call upon waiver of the attorney/client privilege and for counsel to potentially risk violating its duties of professional responsibility relating to confidentiality. Furthermore, it would be difficult for counsel to establish due diligence without revealing

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<sup>36</sup> See CME Group, Market Regulation Advisory Notice, Rule 538, Exchange for Related Positions (Jun. 7, 2021).

<sup>37</sup> NOPR at P 40.

<sup>38</sup> NOPR at n. 48.



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communications had in confidence with a client. Proving “due diligence” may force a client to waive attorney-client privilege and work product protection because showing an investigation needed for due diligence may intrude on attorney advice and thought processes.

### **III. Conclusion**

For the reasons contained herein, FIA respectfully requests that the Commission reconsider the broad application of the NOPR and, at a minimum, revise its proposed duty of candor rule to (i) include a scienter element for intentional or willful misconduct in place of the due diligence standard and (ii) include a well-defined materiality element to differentiate between inadvertent errors or omissions and material issues.

We appreciate FERC’s consideration of our comments. If FERC has any questions or needs any additional information with regard to the matters discussed herein, please contact Michael Sorrell, Deputy General Counsel, at 202-466-5460.

Regards,



Walt Lukken  
President and Chief Executive Officer

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