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16 CFR Part 317

FEDERAL TRADE COMMISSION

[Project No. P082900]

RIN 3084-AB12

Prohibitions On Market Manipulation and False Information in Subtitle B of the Energy Independence and Security Act of 2007

AGENCY: Federal Trade Commission.

ACTION: Advance notice of proposed rulemaking; request for public comment.

SUMMARY: The Federal Trade Commission (FTC or Commission) is requesting comment on the manner in which it should carry out its rulemaking responsibilities under Section 811 of Subtitle B of Title VIII of The Energy Independence and Security Act of 2007 (EISA).

DATES: Comments must be received on or before June 6, 2008.

ADDRESSES: Interested parties are invited to submit written comments electronically or in paper form. Comments should refer to "Market Manipulation Rulemaking, P082900" to facilitate the organization of comments. Comments containing material for which confidential treatment is requested must be filed in paper form, must be clearly labeled "Confidential," and must comply with Commission Rule 4.9(c).[1]

[1] The comment must be accompanied by an explicit request for confidential treatment, including the factual and legal basis for the request, and must identify the specific portions of the comment to be withheld from the public record. The request will be granted or denied by the Commission's General Counsel, consistent with applicable law and the public interest. *See* Commission Rule 4.9(c), 16 CFR 4.9(c) (2008).

Because paper mail in the Washington-area, and specifically to the FTC, is subject to delay due to heightened security screening, please consider submitting your comments in electronic form. Comments filed in electronic form should be submitted by using the following weblink: https://secure.commentworks.com/ftc-marketmanipulationANPR/ (and following the instructions on the web-based form). To ensure that the Commission considers an electronic comment, you must file it on the web-based form at the weblink https://secure.commentworks.com/ftc-marketmanipulationANPR/. If this notice appears at http://www.regulations.gov, you may also file an electronic comment through that website. The Commission will consider all comments that regulations.gov forwards to it. You may also visit the FTC website at http://www.ftc.gov/opa/index.shtml to read the Advance Notice of Proposed Rulemaking and the news release describing it.

A comment filed in paper form should include the "Market Manipulation Rulemaking, P082900" reference both in the text and on the envelope, and should be mailed to the following address: Federal Trade Commission, Market Manipulation Rulemaking, P.O. Box 2846, Fairfax, VA 22031-0846. This address does not accept courier or overnight deliveries. Courier or overnight deliveries should be delivered to: Federal Trade Commission/Office of the Secretary, Room H-135 (Annex G), 600 Pennsylvania Avenue, NW, Washington, DC 20580.

The FTC Act and other laws the Commission administers permit the collection of public comments to consider and use in this proceeding as appropriate. The Commission will consider all timely and responsive public comments that it receives, whether filed in paper or electronic form. Comments received will be available to the public on the FTC website, to the extent practicable, at http://www.ftc.gov. As a matter of discretion, the FTC makes every effort to

remove home contact information for individuals from the public comments it receives before placing those comments on the FTC website. More information, including routine uses permitted by the Privacy Act, may be found in the FTC's privacy policy, at http://www.ftc.gov/ftc/privacy.htm.

FOR FURTHER INFORMATION CONTACT: John H. Seesel, Associate General Counsel for Energy, Federal Trade Commission, Market Manipulation Rulemaking, P.O. Box 2846, Fairfax, VA 22031-0846, (202) 326-3772.

SUPPLEMENTARY INFORMATION:

I. Statutory Framework

Subtitle B of EISA, which became effective on December 19, 2007,[2] includes two substantive sections respectively entitled "Prohibition On Market Manipulation" (Section 811) and "Prohibition On False Information" (Section 812). Section 811 prohibits "any person" from directly or indirectly (1) using or employing "any manipulative or deceptive device or contrivance," (2) "in connection with the purchase or sale of crude oil gasoline or petroleum distillates at wholesale," (3) that violates a rule or regulation that the Federal Trade Commission "may prescribe as necessary or appropriate in the public interest or for the protection of United States citizens." Section 812 prohibits "any person" from reporting information that is "required by law to be reported" -- and that is "related to the wholesale price of crude oil gasoline or petroleum distillates" -- to a Federal department or agency if the person (1) "knew, or reasonably should have known, [that] the information [was] false or misleading;" and (2) intended such false

[2] Pub. L. 110-140, 121 Stat. 1723 (December 19, 2007), Title VIII, Subtitle B, *to be codified at* 42 U.S.C. 17301-17305.

or misleading information "to affect data compiled by the department or agency for statistical or analytical purposes with respect to the market for crude oil, gasoline, or petroleum distillates."

Section 813 provides that Subtitle B "shall be enforced by the Federal Trade Commission in the same manner, by the same means, and with the same jurisdiction" as though "all applicable terms" of the Federal Trade Commission Act (FTC Act) were incorporated into and made a part of Subtitle B. Consequently, any entity subject to Commission jurisdiction under the FTC Act is subject to the Commission's enforcement of Subtitle B, and must comply with Section 812 and any rule promulgated under Section 811 of Subtitle B.[3] Section 813 further provides that the violation of any provision of Subtitle B "shall be treated as an unfair or deceptive act or practice proscribed under a rule issued under section 18(a)(1)(B) of the Federal Trade Commission Act (15 U.S.C. 57a(a)(1)(B))," even though rules and regulations that the Commission may prescribe are to be issued under Subtitle B.[4]

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[3] Section 811 and Section 812 of Subtitle B expressly cover "any person." The Administrative Procedure Act, 5 U.S.C. 551(2), defines "person" as including "an individual, partnership, corporation, association, or public or private organization other than an agency." Similarly, the FTC's jurisdiction under the FTC Act covers "persons, partnerships, or corporations." 15 U.S.C. 45(a)(2). While the FTC Act applies broadly, certain entities are wholly or partly exempt from Commission authority under that Act. These include banks, savings and loan institutions, federal credit unions, transportation and communications common carriers, air carriers, and livestock firms. 15 U.S.C. 45(a)(2). In addition, the term "corporation," as defined in Section 4 of the FTC Act, does not extend to entities not organized to carry on business for their own profit or that of their members. 15 U.S.C. 44.

[4] *See* EISA Section 811 (defining acts or practices that shall be unlawful under "rules and regulations as the Federal Trade Commission may prescribe as necessary or appropriate in the public interest or for the protection of United States citizens"). Because the rulemaking procedures for the issuance of trade regulation rules are limited to rules promulgated "under" Section 18(a)(1)(B) of the FTC Act (*see* 15 U.S.C. 57a(a)(1)(B)), the issuance of rules and regulations under EISA Section 811 is instead governed by the notice-and-comment requirements of the Administrative Procedure Act, 5 U.S.C. 553, and Part 1, Subpart C, of the Commission Rules of Practice for the adoption of non-Section 18 rules. *See* 16 CFR 1.21-1.26.

The Commission could seek a number of different types of relief against a person who violated Subtitle B. In particular, Section 13(b) of the FTC Act permits the Commission to file a federal court civil action seeking a temporary restraining order or a preliminary injunction to prevent any "person, partnership, or corporation" from violating a rule promulgated under EISA Section 811 or from violating EISA Section 812, and to secure a permanent injunction "in proper cases." In such a proceeding, the Commission would also be able to secure corollary equitable relief, such as an asset freeze, disgorgement, and/or the appointment of a receiver. 15 U.S.C. 53(b). Moreover, Section 19 of the FTC Act permits the Commission to file a federal court civil action in its own name against any person, partnership, or corporation that "violates any rule . . . respecting unfair or deceptive acts or practices . . . ,"[5] and permits the court to grant relief needed:

> to redress injury to consumers or other persons, partnerships, and corporations resulting from the rule violation . . . [including but not limited to] rescission or reformation of contracts, the refund of money or return of property, the payment of damages, and public notification respecting the rule violation. . . .[6]

Furthermore, Section 5(m)(1)(A) of the FTC Act permits the Commission, by referral to the Department of Justice, to file a federal court civil action to recover civil penalties of up to $11,000[7] per violation from:

> any person, partnership, or corporation which violates any rule under [the FTC Act] respecting unfair or deceptive acts or practices . . . with actual knowledge or knowledge

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[5] 15 U.S.C. 57b(a)(1).

[6] 15 U.S.C. 57b(b).

[7] This amount has been adjusted upward from the original statutory amount of $10,000 pursuant to the Federal Civil Penalties Inflation Adjustment Act of 1990, as amended by the Debt Collection Improvement Act of 1996. 28 U.S.C. 2461.

> fairly implied on the basis of objective circumstances that such act is unfair or deceptive and is prohibited by such rule.[8]

Because Section 813 of the EISA provides that a violation of Subtitle B shall be treated as a violation of such a rule, any person that violates Subtitle B is subject to these civil penalties.

Section 814(a) of Subtitle B further provides that -- "[i]n addition to any penalty applicable" under the FTC Act -- "any supplier that violates section 811 or 812 shall be punishable by a civil penalty of not more than $1,000,000."[9] Both Section 5(m)(1)(C) of the FTC Act, 15 U.S.C. 45(m)(1)(C), and Section 814(c)(1) of the EISA provide that each day of a continuing violation shall be considered a separate violation.

Section 815(a) provides that nothing in Subtitle B "limits or affects" Commission authority "to bring an enforcement action or take any other measure" under the FTC Act or "any other provision of law." Section 815(b) provides that "[n]othing in [Subtitle B] shall be construed to modify, impair, or supersede the operation" (1) of any of the antitrust laws (as defined in Section 1(a) of the Clayton Act, 15 U.S.C. 12(a)) or (2) of Section 5 of the FTC Act "to the extent that . . . [S]ection 5 applies to unfair methods of competition." Section 815(c) provides that nothing in Subtitle B "preempts any State law."

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[8] 15 U.S.C. 45(m)(1)(A). Section 16(a)(1) of the FTC Act requires the Commission to refer such actions to the United States Attorney General in the first instance, and permits the Commission to file such actions in its own name if "the Attorney General fails within 45 days after receipt of such notification to commence . . . such action." 15 U.S.C. 56(a)(1).

[9] It is not clear whether the use of the term "supplier" in Section 814 is intended to limit use of the remedy available under that section to violations committed by suppliers through *sales* of crude oil, gasoline, or petroleum distillates, or was intended to extend to violations committed by suppliers through *purchases* of such products as well. Commenters are encouraged to discuss this point.

II. Overview of the Advance Notice of Proposed Rulemaking

Section 811 applies to violations of "such rules and regulations as the Federal Trade Commission may prescribe as necessary or appropriate in the public interest or for the protection of United States citizens." This Advance Notice of Proposed Rulemaking seeks public comment from interested parties, including other federal agencies and the States, on whether, and if so in what manner, the Commission should promulgate a rule pursuant to Section 811 in order to ensure that the rule, on balance, carries out the objectives of the statute by prohibiting practices that constitute manipulative or deceptive devices or contrivances to the benefit of the public interest.[10]

The Commission has devoted substantial resources to enforcing the antitrust laws in various parts of the petroleum industry, including in the refining and distribution of crude oil, gasoline, and petroleum distillates. The Commission has also expended significant research efforts in this same space. As a consequence, the Commission and its staff have experience with many parts of the petroleum industry. The Commission will draw upon this foundation in conducting this Rulemaking proceeding.

The Commission's consumer protection efforts provide a second important foundation for conducting this Rulemaking proceeding, and in particular for determining the extent to which the law of unfairness and deception can inform the Commission's interpretation of a

[10] The prohibitions embodied in Section 812 of EISA became effective with enactment of EISA on December 19, 2007. These prohibitions therefore already apply to any person subject to the jurisdiction granted to the Commission by the FTC Act, and the Commission may seek legal and equitable relief to remedy violations of Section 812 in the manner described above, through civil actions in federal court.

"manipulative or deceptive device or contrivance."[11] In interpreting Section 5 of the FTC Act, the Commission has determined that a representation, omission, or practice is deceptive if (1) it is likely to mislead consumers acting reasonably under the circumstances; and (2) it is material, that is, likely to affect consumers' conduct or decisions with respect to the product at issue.[12] Section 5 also provides that an act or practice is unfair if the injury to consumers it causes or is likely to cause (1) is substantial; (2) is not outweighed by countervailing benefits to consumers or to competition; and (3) is not reasonably avoidable by consumers themselves.[13]

As a consequence of the foregoing law enforcement, research, and related efforts -- through both its competition mission and its consumer protection mission -- the Commission and its staff have gained an understanding of the domestic petroleum industry; of how participants in the industry compete; of how prices of gasoline and other refined petroleum products are determined; and of how particular practices may, in specific circumstances, constitute either unfair methods of competition or unfair or deceptive acts or practices, in violation of Section 5 of the FTC Act. The Commission expects to use this experience and understanding to effectuate the

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[11] The term "manipulative or deceptive" arguably can be read as a single adjective. That is the approach the Federal Energy Regulatory Commission followed in promulgating the Final Rule discussed *infra*, in reliance on the fact that, with respect to Securities Rule 10b-5 cases, the Supreme Court had "concluded that both [manipulative and deceptive] require 'misrepresentation.'" *Federal Energy Regulatory Commission, 18 CFR Part 1c: Prohibition of Energy Market Manipulation: Final Rule*, 71 FR 4244, 4253 n. 107 (January 26, 2006). By contrast, however, the FTC has for many years vigorously enforced the separate prohibition of "deceptive acts or practices" embodied in Section 5 of the FTC Act, 15 U.S.C. 45.

[12] *See generally* Federal Trade Commission Policy Statement on Deception, *appended to Cliffdale Assocs.*, 103 F.T.C. 110, 174-83 (1984).

[13] 15 U.S.C. 45(n); *see generally* Federal Trade Commission Policy Statement on Unfairness, appended to *International Harvester, Co.,* 104 F.T.C. 949, 1070-76 (1984). Neither deception nor unfairness requires a showing of scienter.

objectives of Subtitle B. Through this Advance Notice of Proposed Rulemaking, the Commission expects to secure new and valuable information concerning how best to achieve those objectives. Commenters are encouraged to review this document in its entirety and offer comments concerning any of the points or questions raised, as well as any other relevant issue.

III. The Antecedents of Section 811 and Relevant Legal Precedent

The manner in which the courts and regulatory agencies have interpreted provisions similar to those comprising Section 811 is relevant both to formulating a rule under Section 811 and to determining how the resultant formulation will fare in the courts. Public comment will provide critical information in that regard. While there are substantial similarities among prior interpretations and their contexts, there are substantial differences as well. In order to provide a framework within which commenters can develop and provide their own assessments for purposes of considering a rule under Section 811, we offer a brief discussion of the statutory and regulatory antecedents of Section 811, and court interpretations of similar statutes and regulations. The Commission encourages comment on these or any other aspects of precedent that may help to guide the Commission's approach in this Rulemaking.

Establishing a violation of Section 811 first requires a showing that a person[14] directly or indirectly used or employed a "manipulative or deceptive device or contrivance." In determining the contours of this requirement -- including determining the state of mind that is required -- commenters are encouraged to address the extent to which the Commission can or should rely on four separate sets of existing statutory and regulatory constructs, discussed below.

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[14] For the reasons discussed *supra*, the term "person" is used in this document to refer to "person, partnership, or corporation," consistent with the jurisdictional reach of the FTC Act.

A. The Securities Laws

The phrase "manipulative or deceptive device or contrivance" derives from the Securities Exchange Act of 1934 (Exchange Act). Section 10(b) of that statute prohibits the use or employment of:

> any *manipulative or deceptive device or contrivance* in contravention of such rules as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[15]

The Securities and Exchange Commission (SEC) relied on Section 10(b) of the Exchange Act to promulgate Rule 10b-5, which makes it unlawful for any person:

> (a) To employ any device, scheme, or artifice to defraud;
> (b) To 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) To 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.[16]

In 1976, the Supreme Court determined that a private cause of action for damages would not lie under Section 10(b) or Rule 10b-5 without proof that the defendant possessed scienter; that is, the "intent to deceive, manipulate, or defraud."[17] In particular, the Court noted:

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[15] 15 U.S.C. 78j(b) (emphasis added). Section 9 of the Exchange Act more specifically addresses "Manipulation of security prices," and prohibits or limits the use of certain practices with respect to "[t]ransactions relating to purchase or sale of security;" "[t]ransactions relating to puts, calls, straddles, or options;" "[e]ndorsement or guarantee of puts, calls, straddles, or options;" and "practices that affect market volatility." 15 U.S.C. 78i(a),(b),(c),(h).

[16] 17 CFR 240.10b-5(a)-(c) (2008). In addition, the SEC's rules under Section 10(b) prohibit a number of specific practices in specific circumstances. *See* 17 CFR 240.10b-1 through 240.10b-18.

[17] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); *accord, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. ___ (June 21, 2007), slip op. at 1-2, 7; *In re Worlds of*

> Section 10(b) makes unlawful the use or employment of "any manipulative device or contrivance" in contravention of [Securities and Exchange] Commission rules. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that [Section] 10(b) was intended to proscribe knowing or intentional misconduct.[18]

Moreover, the Court found that use of the terms "[t]o use or employ" supported "the view that Congress did not intend [Section] 10(b) to embrace negligent conduct."[19] The Court concluded that "the language of [Section] 10(b) . . . clearly connotes intentional misconduct. . . ."[20] Soon thereafter, the Court determined that the SEC, as well as private plaintiffs, must:

> establish scienter as an element of a civil enforcement action to enjoin violations of . . . [Section] 10(b) of the [Securities Exchange Act of 1934], and Rule 10b-5 promulgated under that section of the 1934 Act.[21]

Wonder Securities Litigation, 35 F.3d 1407, 1424 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 185 (1995); *Loveridge v. Dreagoux*, 678 F.2d 870, 875 (10th Cir. 1982).

[18] *Ernst & Ernst,* 425 U.S. at 197. The Court concluded that the terms

> "manipulative," "device," and "contrivance" . . . make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence. Use of the word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.

Id. at 199 (internal citations omitted). *See also Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 6-7 (1985); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977) (the term "manipulation" "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.").

[19] *Id*. at 199 n. 20.

[20] *Id*. at 201, *citing United States v. Oregon*, 366 U.S. 643, 648 (1961); *Packard Motor Car Co. v. NLRB*, 330 U.S. 485, 492 (1947); *accord, e.g., Aaron v. Securities and Exchange Commission*, 446 U.S. 680, 690 (1980).

[21] *Aaron v. SEC*, 446 U.S. at 701-702.

While the Supreme Court has reserved the question

> whether reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5, . . . [e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required.[22]

More generally, the Court of Appeals for the Second Circuit has elaborated that, in order to establish a Rule 10b-5 violation, the SEC must establish that the defendant:

> (1) [m]ade a material misrepresentation or a material omission as to which he had a duty to speak, or used a fraudulent device; (2) with scienter; and (3) in connection with the purchase or sale of securities.[23]

B. The Natural Gas Act and the Federal Power Act

The Energy Policy Act of 2005 amended the Natural Gas Act and the Federal Power Act, respectively, to prohibit the same type of conduct that Section 10(b) of the Exchange Act targets -- that is, the use or employment of "any manipulative or deceptive device or contrivance (as those terms are used in [Section 10(b) of the Securities Exchange Act of 1934] . . .)."[24] In 2006, the Federal Energy Regulatory Commission (FERC) relied on those prohibitions to promulgate two rules -- respectively prohibiting natural gas market manipulation and electric energy market manipulation (collectively referred to as the Final Rule). The FERC Final Rule is identical in many respects to SEC Rule 10b-5.[25] FERC also determined to interpret the Final Rule in a

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[22] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. ___ (June 21, 2007), slip op. at 7 n. 3, *citing Ernst & Ernst v. Hochfelder*, 425 U.S. at 194 n. 12; *Ottman v. Hanger Orthopedic Group, Inc*., 353 F.3d 338, 343 (collecting Court of Appeals cases).

[23] *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999).

[24] *Compare* Section 4A of the Natural Gas Act, 15 U.S.C. 717c-1, *with* Section 222 of the Federal Power Act, 16 U.S.C. 824v.

[25] 18 CFR 1c.1, 1c.2 (2008).

manner "consistent with analogous SEC precedent that is appropriate under the circumstances."[26] In particular, FERC included a scienter requirement, noting that "[t]he final rule is not intended to regulate negligent practices or corporate mismanagement, but rather to deter or punish fraud in wholesale energy markets,"[27] and that "there can be no violation of the final rule, or any of its sections, absent a showing of the requisite scienter."[28] FERC determined that a showing of recklessness would be sufficient to satisfy the scienter requirement under the FERC Final Rule.[29] FERC expressly declined to incorporate "a specific intent standard" into the Final Rule.[30]

FERC relied on the foregoing analysis to determine that it will take action pursuant to the Final Rule in cases where an entity:

> (1) [u]ses a fraudulent device, scheme or artifice, or makes a material misrepresentation or a material omission as to which there is a duty to speak under a Commission-filed tariff, Commission order, rule or regulation, or engages in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) with the requisite scienter; (3) in connection with the purchase or sale of natural gas or electric energy or transportation of natural gas or transmission of electric energy subject to the jurisdiction of the Commission.[31]

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[26] *Federal Energy Regulatory Commission, 18 CFR Part 1c: Prohibition of Energy Market Manipulation: Final Rule*, 71 FR 4244, 4246 (January 26, 2006).

[27] *Id.* at 4246.

[28] *Id*. at 4252; *accord, id*. at 4253, *citing Ernst & Ernst v. Hochfelder*, 425 U.S. at 197; *Aaron v. SEC*, 446 U.S. at 690.

[29] *Id*. at 4253-54 and n. 109 ("Courts of appeal are in general agreement that recklessness in some form satisfies the scienter requirement of SEC Rule 10b-5.") (citations omitted).

[30] *Id*. at 4253.

[31] *Id.* at 4253.

FERC defined fraud "generally . . . to include any action, transaction, or conspiracy for the purpose of impairing, obstructing, or defeating a well-functioning market."[32] FERC also provided examples of practices that would violate the Final Rule because the practices constituted "manipulative or deceptive devices or contrivances." FERC's cited practices were already prohibited by its Market Behavior Rule 2 (since-repealed), but included in particular:

> wash trades, transactions predicated on submitting false information, transactions creating and relieving artificial congestion, and collusion for the purpose of market manipulation.[33]

FERC also determined to incorporate the "safe harbor presumptions of compliance and affirmative defenses" available under its Market Behavior Rules into its enforcement of the Final Rule.[34] FERC rejected the argument registered by some commenters that its rule was "vague and overly broad," noting that it was modeled after SEC Rule 10b-5, and that the courts have determined that the latter rule is neither vague nor overly broad.[35]

FERC's statute specifically limited its application to actions "in connection with a jurisdictional transaction." Relying on cases addressing Section 10(b) of the SEC, in its Final

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[32] *Id.*, *citing Dennis v. United States*, 384 U.S. 855, 861 (1966).

[33] *Id.* at 4254.

[34] *Id.* at 4255. Thus, for example, FERC will presume that a market participant that "undertakes an action or transaction that is explicitly contemplated in Commission-approved rules and regulations" does not violate the Final Rule. Moreover, if a market participant takes an action or engages in a transaction -- at the direction of an Independent System Operator or a Regional Transmission Organization, but not approved by FERC -- it can assert that as a defense for the action taken.

[35] *Id.* at 4250, *citing United States v. Persky*, 520 F.2d 283 (2d Cir. 1975); *Todd & Co. v. SEC*, 557 F.2d 1008, 1013 (3d Cir. 1977).

Rule, FERC defined "in connection with" to mean that "in committing fraud, the entity must have intended to affect, or have acted recklessly to affect, a jurisdictional transaction."[36]

FERC's first litigated case under the Final Rule provides a helpful illustration of how it intends to enforce the Final Rule in practice. In that case, FERC issued an Order to Show Cause and Notice of Proposed Penalties against hedge fund Amaranth LLC, and two traders, alleging that they had illegally manipulated the price of transactions subject to FERC jurisdiction by trading in the New York Mercantile Exchange (NYMEX) Natural Gas Futures Contracts for February, March, and April of 2006. In particular, the Order alleged that the respondents intentionally manipulated the final, or "settlement," price of the NYMEX Natural Gas Futures Contract -- on three occasions in 2006 -- by selling an extraordinary quantity of these contracts during the last 30 minutes of trading before they expired, with the purpose and effect of driving down the settlement price. The settlement price is explicitly used to determine the price for a substantial volume of physical natural gas transactions subject to FERC jurisdiction, and Amaranth had previously taken positions in various financial derivatives that were several times larger -- and whose values increased -- as a direct result of the fall in the settlement price of each natural gas futures contract. As a consequence, for every dollar Amaranth lost on its sales of the futures contracts, Amaranth gained several dollars on its derivative financial positions.[37] The Order gave Amaranth 30-days to show cause why it should not be assessed $200 million in civil

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[36] *Id*. at 4249.

[37] *Commission Takes Preliminary Action in Two Major Market Manipulation Cases*, Federal Energy Regulatory Commission News (July 26, 2007), *available at* http://www.ferc.gov/news/news-releases/2007/2007-3/07-26-07.pdf.

penalties and be required to disgorge profits totaling $59 million, plus interest. The case remains in litigation.[38]

C. The Commodity Exchange Act

Interpretation of the first component of Section 811 can also be informed by the manner in which the concept of "manipulation" has been defined in cases arising under the Commodity Exchange Act (CEA).[39] That statute empowers the CFTC, *inter alia*, to bring an administrative enforcement action, or a civil injunctive action in federal district court against:

> any person (other than a registered entity) [who] is manipulating or attempting to manipulate or has manipulated or attempted to manipulate the market price of any commodity, in interstate commerce, or for future delivery on or subject to the rules of any registered entity. . . .[40]

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[38] On July 25, 2007, the Commodity Futures Trading Commission (CFTC) filed a civil enforcement action in federal district court against Amaranth challenging many of the same actions at issue in the FERC proceeding described above. The CFTC is seeking permanent injunctive relief, an award of civil penalties, and other remedial and ancillary relief. The CFTC and FERC both noted that they had coordinated their respective investigations, pursuant to the agencies' Memorandum of Understanding. The ultimate resolution of the CFTC and FERC cases will provide important guidance concerning the interaction between their respective statutes and rules with respect to manipulation. *See U.S. Commodity Futures Trading Commission Charges Hedge Fund Amaranth and its Former Head Energy Trader, Brian Hunter, with Attempted Manipulation of the Price of Natural Gas Futures*, Commodity Futures Trading Commission News (July 25, 2007), *available at* http://www.cftc.gov/newsroom/enforcementpressreleases/2007/pr5359-07.html.

[39] The CEA provides that the CFTC possesses, *inter alia*, "exclusive jurisdiction" for "transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . . or derivatives transaction execution facility . . . or any other board of trade, exchange, or market. . . ." 7 U.S.C. 2(a)(1)(A). It further provides for non-exclusive CFTC anti-manipulation authority over cash and physical transactions, as well as certain derivatives transactions relating to securities. 7 U.S.C. 2(a)(1)(A), (C), (D).

[40] 7 U.S.C. 9, 13b; *see* 7 U.S.C. 15. The statute defines a "registered entity" as including certain boards of trade designated as contract markets; derivatives transaction execution facilities; and "derivatives clearing organizations." 7 U.S.C. 1a(29).

In addition, Section 9(a)(2) of the CEA makes it a felony for:

> [a]ny person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity . . . .[41]

The CEA also requires any board of trade (defined as any organized exchange or other trading facility[42]) that wishes to be designated as a contract market, *inter alia,* to comply with a variety of statutory "Core Principles."[43]

The Supreme Court decision in *Merrill Lynch v. Curran* provides an extensive discussion of the origins of futures trading and the CEA, and of how the foregoing statutory proscriptions of manipulation should be interpreted.[44] In particular, the Court held that the primary purpose of the 1974 amendments to the CEA was to protect "against manipulation of markets and to protect any individual who desires to participate in futures market trading."[45]

D. <u>The Sherman Act, the Clayton Act, and the Federal Trade Commission Act</u>

The enactment of Subtitle B raises the important question of the extent to which the Commission should rely upon antitrust and consumer protection precedent as a frame of reference for this Rulemaking proceeding. The legislation gave the Commission new law

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[41] 7 U.S.C. 13(a)(2).

[42] 7 U.S.C. 1a(2).

[43] 7 U.S.C. 7(d).

[44] *Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Curran*, 456 U.S. 353 (1982).

[45] *Id.* at 372, n. 50. Subsequently, the Commodity Futures Modernization Act of 2000 identified the purposes of the CEA as including, *inter alia*, "to deter and prevent price manipulation or any other disruptions to market integrity. . ." 7 U.S.C. 5(b). *See also Frey v. Commodity Futures Trading Commission,* 931 F.2d 1171, 1175 (7th Cir. 1991).

enforcement tools to prevent both market manipulation and the reporting of false information. However, the extent to which law enforcement agencies have been able to prevent manipulation or deception in the past may provide useful lessons as commenters offer their input as to how best to effectuate EISA Section 811 and the statutory objectives it represents.

In the context of antitrust law, the term "manipulative or deceptive device or contrivance" is not a term of art. But, practices that potentially fall within the definition of those terms have been analyzed in the past through the prism of the Sherman Act Section 1 prohibition against certain unreasonable contracts, combinations and conspiracies in restraint of trade; through the Sherman Act Section 2 prohibition against monopolization, attempts to monopolize, and conspiracies to monopolize; and through the FTC Act prohibition against unfair methods of competition.

For example, 60 years ago, the Supreme Court addressed the concept of manipulation in the petroleum industry in *United States v. Socony-Vacuum Oil Co.* In that case, 12 oil companies and five individuals violated Section 1 of the Sherman Act by operating the "Mid-Continent Buying Program" and the "East Texas Buying Program."[46] The defendant participants in these two programs agreed that they would purchase tank cars of "distress gasoline" from independent

[46] *United States v. Socony-Vacuum Oil Co., Inc., et al*., 310 U.S. 150, 181-90 (1940).

oil refiners.[47] Thereafter, the participants in the Mid-Continent Buying Program held monthly meetings at which each participant would advise the others of "how much his company would buy and from whom."[48]

The Supreme Court determined that the:

> whole scheme was carefully planned and executed to the end that distress gasoline would not overhang the markets and depress them at any time. And as a result of the payment of fair going market prices a floor was placed and kept under the spot markets. Prices rose and jobbers and consumers in the Mid-Western area paid more for their gasoline than they would have paid but for the conspiracy. Competition was not eliminated from the markets; but it was clearly curtailed, since restriction of the supply of gasoline, the timing and placement of the purchases under the buying programs and the placing of a floor under the spot markets obviously reduced the play of the forces of supply and demand.[49]

The Court determined that the purchases "at or under the market are one species of price-fixing,"[50] and that "there was substantial competent evidence that the buying programs resulted in an increase of spot market prices, of prices to jobbers and of retail prices in the Mid-Western area."[51] The Court concluded that the buying programs, by stabilizing market prices, constituted "one form of manipulation," and defined "market manipulation in its various manifestations" as:

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[47] For example, in the Mid-Continent oil field, 17 independent refiners did not have regular outlets for their gasoline, and because they had to keep their refineries running, they had to sell approximately 600 to 700 tank cars of gasoline each month at "distress" prices. *Id*. at 178-79. For similar reasons, a number of independent refiners in the East Texas oil field had to sell a substantial number of tank cars of gasoline at "distress" prices. *See id*. at 185-90.

[48] *Id.* at 182. The East Texas Buying Program followed a similar approach with respect to independent refiners in the East Texas oil field. *Id*. at 185-90.

[49] *Id.* at 220.

[50] *Id.* at 223.

[51] *Id.* at 251. The Court rejected as irrelevant the defendants' arguments that the prices at issue were reasonable, and that their activities "merely removed from the market the depressive effect of distress gasoline. . . ." *Id.* at 229.

> an artificial stimulus applied to (or at times a brake on) market prices, a force which distorts those prices, a factor which prevents the determination of those prices by free competition alone.[52]

The *Socony-Vacuum* decision is among many in antitrust and consumer protection law that may provide useful guidance to the Commission in determining the metes and bounds of manipulative conduct under Subtitle B.[53] To the extent commenters believe the Commission should be aware of particular antitrust or consumer protection law decisions, commenters are encouraged to discuss the cases and provide an explanation of the lessons to be incorporated from those opinions.

In addition, unlike the SEC, CFTC, and FERC, the Commission has long had authority to prevent "unfair or deceptive acts or practices."[54] That prohibition is not limited to "devices or contrivances," and violations do not require proof of actual fraud or intent to deceive. The Commission seeks comments on any guidance its experience with unfair or deceptive acts or practices should or could provide in implementing its new authority.[55]

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[52] *Id.* at 223.

[53] Other cases that may be of interest include *Verizon Communications Inc. v. Law Offices of Curtis v. Trinko, LLP*, 540 U.S. 398 (2004)*; Eastman Kodak v. Image Technical Services,* 504 U.S. 451, 455-56 (1992)*; Aspen Skiing Co. v. Aspen Highlands Skiing Corp*., 472 U.S. 585, 601 (1985); and *Virtual Maintenance Inc. v. Prime Computer Inc.*, 11 F.3d 660, 662 (6th Cir. 1993). This list is not intended to be exhaustive, but merely illustrative.

[54] *See supra* for the criteria the Commission uses under the FTC Act.

[55] Please note that nothing in connection with this Section 811 Rulemaking, any subsequently enacted rules, or related efforts should be construed to alter the standards associated with establishing a deceptive practice or an unfair practice in a case brought by the Commission.

E. Reflecting on the Legal Framework – Questions for Commenters

The conduct component of Section 811 derives from a similar prohibition in Section 10(b) of the Securities Exchange Act of 1934 -- as implemented by the SEC through its promulgation and enforcement of Rule 10b-5 -- and from the 2005 amendments to the Natural Gas Act and the Federal Power Act, as implemented through regulations promulgated and enforced by FERC. The Commodity Exchange Act, as enforced by the CFTC, and the antitrust laws provide additional guidance as to the manner in which the Supreme Court and lower courts have interpreted the manipulation concept.

Commenters are encouraged to assess whether, and if so to what extent, a Section 811 rule should incorporate or otherwise reflect any other aspects of these statutory and federal court precedents. Commenters are encouraged to assess whether these statutory and federal court precedents indicate that a Section 811 rule should prohibit a person from using or employing "any manipulative or deceptive device or contrivance" only if that person possesses the scienter -- to execute the allegedly manipulative strategy at issue -- that is analogous to the general intent to injure competition component of the monopolization offense under Section 2 of the Sherman Act and Section 5 of the Federal Trade Commission Act. In addition, commenters are encouraged to assess whether, and if so to what extent, a Section 811 rule should incorporate or otherwise reflect the FTC Act prohibition of unfair or deceptive acts or practices.[56]

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[56] The Commission notes that neither knowledge nor intent need be shown to prove a deceptive practice or an unfair practice under Section 5 of the FTC Act. *See, e.g., FTC v. Bay Area Business Council, Inc.*, 423 F.3d 627, 635 (7th Cir. 2005); *FTC v. Freecom Communications, Inc.*, 401 F.3d 1192, 1202 (10th Cir. 2005); *FTC v. Amy Travel Serv., Inc.*, 875 F.2d 564, 573-74 (7th Cir. 1989).

In addition, in the Commission's 2006 *Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases Report to Congress*,[57] the Commission described and looked for a number of types of practices and circumstances in various components of the petroleum refining and distribution system that might be viewed as manipulative.[58] Commenters are encouraged to discuss whether a Section 811 rule should limit or prohibit any of these types of practices and, if so, in what circumstances, including discussing the direct and indirect benefits and costs of doing so. Commenters are also encouraged to discuss conduct in connection with the purchase and sale of crude oil, which, though outside the scope of the 2006 report, is within the reach of Section 811.

IV. Particular Questions For Commenters

Below is a general framework within which commenters are encouraged to discuss what they believe the contours of a Section 811 rule should be. The Commission encourages commenters to answer specific questions, and to focus in particular on defining manipulative or deceptive behavior, in order to help the Commission formulate a workable rule that on balance benefits consumers.

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[57] Federal Trade Commission Report to Congress, *Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases* (Spring 2006). Commenters may consider this report a useful primer on the industry.

[58] The Commission examined: "(1) all transactions and practices that are prohibited by the antitrust laws, including the Federal Trade Commission Act, and (2) *all other transactions and practices, irrespective of their legality under the antitrust laws, that tend to increase prices relative to costs and to reduce output.*" *Id.* at ii (emphasis added). The Commission made clear, however, that this definition for purpose of the report represented neither existing legal prohibitions nor, in its view, an identification of practices that should be prohibited.

A. Defining Market Manipulation

The Commission is considering various possible definitions of market manipulation for the purpose of this Rulemaking under Section 811. One possible definition is the following:

> *Market manipulation shall mean knowingly using or employing, directly or indirectly, a manipulative or deceptive device or contrivance -- in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale -- for the purpose or with the effect of increasing the market price thereof relative to costs.*

The Commission seeks comment on whether this proposed definition of market manipulation is one under which a rule may be adopted that is "necessary and appropriate in the public interest or for the protection of United States citizens," as required by Section 811. The Commission also seeks comment on whether an effect on prices should be a necessary element of proof under either a charge of market manipulation or a charge of attempted market manipulation. In addition, the Commission encourages commenters to suggest any other definitions that, in their view, may better address the public policy concern enunciated through the Commission's new rulemaking authority.

B. Manipulative or Deceptive Device or Contrivance

As discussed above, Section 811 is modeled on authority previously granted to the SEC, FERC, and the CFTC. The Commission encourages commenters to address how Section 811's rulemaking authority should be exercised in light of the similar authority granted to the SEC and to FERC. In particular, the Commission seeks comments on how legal precedent established for violations of rules addressing manipulation or deceit in regulated behavior (such as securities

trading or the execution of transactions carried out by regulated entities) should apply to unregulated behavior, such as the purchase and sale at wholesale of crude oil, gasoline, or petroleum distillates. To what extent (or in what particulars) should the jurisprudence under the other laws addressing manipulation apply under the Commission's new authority? What should not apply? The Commission encourages commenters to identify both general criteria and specific applications of the other laws, and to explain why each should or should not apply under a Section 811 rule, with a specific discussion of the costs and benefits of application

The Commission also seeks comment on the potential costs or benefits of an FTC rule that simply mirrors the language of SEC Rule 10b-5 or the language of the FERC Final Rule. In particular, could a Section 811 rule, that is similar to the rules adopted by the SEC and FERC for their specific purposes, provide sufficient clarity as to prohibited practices in the different context of crude oil, gasoline, and petroleum distillates transactions? In addition, commenters are asked to consider whether a rule that provides more specificity would be adequately broad and flexible to allow the Commission to address new and varied types of manipulation and deception. If the Commission develops a rule with more specific guidance and standards, what should those standards be?

In the larger context discussed above, the Commission also seeks comment on the regulatory authority granted to the other federal agencies, and the potential or actual impact on consumer prices from the exercise of this authority. In addition, the Commission encourages commenters to address whether an anti-manipulation rule promulgated under Section 811 could be a mechanism for abuse by customers, competitors, or others.

C. Effect on the Market

As indicated in a number of the cases discussed above, as well as the FERC rulemaking, the primary focus of the prohibition on manipulation appears to be on practices that are not a reaction to market forces. Instead, the focus is on practices that intentionally, willfully, or recklessly cause distortions in the market, such as artificially raising or depressing prices. Commenters are encouraged to consider whether this should be a focus of a potential Section 811 rule.

D. Scienter/State of Mind

In determining whether particular conduct violates any of the statutory and regulatory proscriptions, the federal courts have required a showing that the defendants or respondents were not simply negligent, but rather possessed at least the requisite scienter to execute the manipulative practice in question.

For example, the courts have interpreted Section 10(b) of the SEA to require a showing of scienter -- that is, of intentional, willful, or reckless conduct designed to deceive or defraud by controlling or artificially affecting market prices or market activity. FERC relied on that precedent to incorporate a scienter requirement into its Final Rule. By contrast, the courts and the CFTC have interpreted the CEA and its implementing regulations as requiring a showing of a specific intent to injure a futures market through the execution of an intentionally manipulative strategy. The Commission seeks comment on the appropriate nature and level of scienter for a violation, and on whether that determination should depend on the nature of the practice at issue (and, if so, in what way). An additional question for consideration includes whether the Commission should incorporate either of the above scienter standards into a Section 811 rule.

Commenters are encouraged to provide a specific discussion of the costs and benefits of the standard they recommend.

E. In Connection With

Establishing a violation of Section 811 also requires establishing that the conduct at issue was used or employed "in connection with the purchase or sale of crude oil[,] gasoline[,] or petroleum distillates at wholesale."[59] As a consequence, Section 811 does not extend to retail sales of gasoline. Instead, it arguably covers sales and purchases starting at the point at which crude oil, gasoline, or a petroleum distillate is sold by the producer or importer, and ending at the point at which it is purchased by a retailer. Commenters are encouraged to discuss how the phrase "in connection with the sale or purchase of crude oil, gasoline, or petroleum distillates at wholesale" should be interpreted. In relying on cases addressing Section 10(b) of the SEA to promulgate its Final Rule, FERC defined "in connection with" to mean that "in committing fraud, the entity must have intended to affect, or have acted recklessly to affect, a jurisdictional transaction."[60] The Commission specifically seeks guidance as to whether the FERC model is appropriate for adoption by the Commission.

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[59] The phrase "crude oil gasoline or petroleum distillates," without commas, is used in Section 811 (as well as in the first clause of Section 812), while the phrase "crude oil, gasoline, or petroleum distillates" (with commas) is used in Section 812(3). This is presumably a non-substantive typographical error; therefore, all parts of both Sections should be read to cover all three types of products (that is, crude oil, gasoline, and petroleum distillates).

[60] 71 FR 4249, *quoting SEC v. Zandford*, 535 U.S. 813, 825 (2002) (the Supreme Court has construed the "in connection with" requirement broadly, "to encompass many circumstances where securities transactions 'coincide' with the overall scheme to defraud").

F. In the Public Interest or For the Protection of United States Citizens

Establishing a violation of Section 811 also requires a showing that the practices "used or employed" violate a rule that the Commission has prescribed "as necessary or appropriate in the public interest or for the protection of United States citizens." Commenters are encouraged to address how the Commission may best ensure that a Section 811 rule satisfies this standard. Commenters are also encouraged to discuss whether antitrust or consumer protection principles should or should not be incorporated at all into a Section 811 rule. For example, the Commission seeks comment on whether a Section 811 rule should conform to traditional antitrust analysis by requiring (1) the use or employment of "any manipulative or deceptive device or contrivance" to satisfy the anticompetitive conduct component of the offenses of monopolization and attempted monopolization prohibited by Section 2 of the Sherman Act and (2) the intent and market power components of those offenses to be satisfied under the standards

explained throughout antitrust case law.[61] Commentors are asked to explain whether such a construction is necessary or appropriate in the context of this Rulemaking.

G. Penalties

Section 814 provides civil penalty authority of up to $1,000,000, which can be assessed against "suppliers" for each violation for each day, taking into consideration the seriousness of the violation and any attempts by the violator to mitigate the harm. The Commission seeks comment on whether any potential chilling effect of these penalties on legitimate business behavior should affect the interpretation of, or required state of mind for, a "manipulative deceptive device or contrivance." The Commission also seeks comment on whether the Section 814 civil penalty authority extends only to violations committed by suppliers through sales of crude oil, gasoline, or petroleum distillates, or is intended to extend to violations committed by suppliers through purchases of such products as well.

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[61] The Supreme Court has defined market power as the power "'to force a purchaser to do something that he would not do in a competitive market,'" and as "'the ability of a single seller to raise price and restrict output.'" *Eastman Kodak Co. v. Image Technical Services*, 504 U.S. 451, 464 (1992), *citing Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 14 (1984); *accord, e.g.*, *United States v. Dentsply Int'l, Inc*., 399 F.3d 181, 187 (3d Cir. 2005); *United States v. Microsoft Corp.*, 253 F.3d 34, 51 (D.C. Cir.), *cert. denied*, 534 U.S. 952 (2001). Consistent with that determination, the *Horizontal Merger Guidelines* define market power as to a seller as "the ability profitably to maintain prices above competitive levels for a significant period of time." U.S. DEP'T OF JUSTICE & FEDERAL TRADE COMM'N, HORIZONTAL MERGER GUIDELINES (1992), Section 0.1, at 4; *accord, Tops Markets, Inc. v. Quality Markets, Inc*., 142 F.3d 90, 99 (2d Cir. 1998); *United States v. Syufy Enters*., 903 F.2d 659, 665-66 (9th Cir. 1990). As the Commission has noted, although the terms "market power" and "monopoly power" are often treated as synonymous from an economic perspective, market power can be thought of as a continuum along which the power to control prices varies, beginning with the complete absence of market power at one end and ending with monopoly power at the other. *International Telephone & Telegraph Co.*, 104 F.T.C. 280, 411 n. 60 (1984).

H. Overlapping Jurisdiction

As noted above, Congress has provided anti-manipulation authority to FERC and the CFTC to reach behavior previously not regulated by those agencies. In some cases, this authority may lead to a shared jurisdiction over the same behavior. The manipulation authority provided by Section 811 may subject market participants to similar overlapping agency oversight, and create the potential for market participants to be subject to differing standards of conduct and multiple levels of liability. The Commission seeks comment on the possible effects of this type of overlapping jurisdiction. The Commission also seeks comment on the usefulness of inter-agency information sharing on market manipulation regulation law enforcement; on reducing costs; on speeding enforcement actions; on other potential benefits or costs for consumers and businesses; and, on how it can best harmonize its enforcement efforts with those of FERC and the CFTC.

I. Potential Practices

The Commission requests comment on the following topic list, but encourages commenters to present any other proposals for formal rule provisions that they may wish to suggest. This list is not to be perceived as a formal proposal to address any of the practices described pursuant to Section 811; rather, it is intended to be illustrative, and to encourage further thinking.

- Certain refiners have made public announcements of planned reductions in the overall utilization of their refinery plant(s). The Commission seeks comment on: (1) whether such practices should be viewed as manipulative; (2) the perceived harm from such actions, if any; (3) whether such practices should or would manifest the intent necessary

to violate Section 811; and (4) whether any business justifications balance the perceived harm.

- Refiners engage in periodic scheduled maintenance and refinery downtime in order to prevent breakdowns or to change equipment. On the one hand, such maintenance and scheduled downtime are necessary for the safe and efficient operation of petroleum refineries; on the other hand, public announcements of downtime may enable competitors to collude inappropriately. The Commission therefore seeks comment on both the costs and the benefits of a rule restricting public pre-announcements of such downtime.
- Wholesale petroleum market participants frequently rely on independent published data for market prices in effecting purchase and sale contracts and other supply arrangements. In the past, Commission staff have received allegations of false or misleading physical sales reports furnished to private reporting entities by market participants in thinly traded petroleum commodity markets. The Commission seeks comment on experiences with this practice, the likelihood the practice could drive false or misleading market prices, the ability of a market manipulation rule effectively to police such activities, and the potential benefits or harm to public data sources or private data compilation services.
- The Commission seeks comment on the circumstances, if any, under which a firm's decision regarding supplying a market (including whether to reduce, increase, or maintain unchanged the amount it supplies) should be considered manipulative or deceptive. Commenters are encouraged to address both the immediate and the long-term costs and benefits to consumers of permitting, prohibiting, or restricting such actions, as well as the effects such decisions would have during a time of national emergency or natural disaster.

- Some have argued that market participants with terminal or other storage inventory should be under an affirmative obligation to release inventory during price spikes when the participant knows, or should know, that the release of the product will be profitable. The Commission seeks comment on when such an obligation should be imposed; what possible intent standard should be used as a test for liability; how one should measure profitability in such a circumstance; and, the costs and benefits to consumers of placing such an obligation on potential market suppliers.
- FERC and state regulations govern open access to common carrier pipelines. In some circumstances, prospective shippers on a given common carrier pipeline may lack the ability to access that pipeline due to an inability to place product in a terminal from which to enter the pipeline system, or because those shippers lack a terminal from which to exit the pipeline system. The Commission seeks comment on whether a denial of access to a non-regulated terminal may be an act of market manipulation subject to Section 811, and on whether applying the rule to this behavior is likely to result in benefits that outweigh the costs.
- Regulated petroleum pipelines may not allow new shippers a share of a pipeline's capacity when historical shippers seek to transport more petroleum products than the pipeline is capable of transporting. The Commission seeks comment on whether pre-announcements that pipelines are approaching capacity constraints may be a conduit for market manipulation or deceit under Section 811, and on whether applying the rule to this behavior is likely to result in benefits that outweigh the costs.

- Accurate cost and volume data for wholesale transactions at all levels of trade, refinery or pipeline outage data, and import and inventory volumes are frequently difficult to construct or are unavailable. The Commission seeks comment on whether it possesses the authority to promulgate a rule under Section 811 requiring a covered person to maintain and submit such information to the Commission or any other government entity, and, if so, whether it should do so, and what particular data it should require.
- The Commission seeks comment on how to determine an artificial price. For example, if an entity with market power that was not obtained by improper means, sets its prices above what would have been a competitive level, and as a result, prices in the market are higher than competitive prices, is this an artificial price? Commenters are encouraged to explain how the competitive price should be determined, including during a period in which capacity has declined unexpectedly because of a disaster. Commenters are encouraged to assess, in particular, whether setting the prices above a competitive level should be considered a manipulative device or contrivance; whether that answer would depend on other factors or circumstances, and, if so, on which ones; and what the direct and indirect, short- and long-term effects of treating this as a manipulative device or contrivance would be.
- The Commission seeks comment as to what extent or in what circumstances should the distinction between forbidden and permitted business behavior be primarily a function of the intent, purpose, or knowledge of the actor? For example, if a firm holds back inventory during a supply shortage with the intent to raise or expectation of raising immediate prices, but the effect is that the inventory is sold later, when the shortage is

more severe, and thus mitigates the more severe shortage, should that be a violation? If a firm decreases the amount of product sold in a tight market in order to grow its business elsewhere, regardless of whether prices in the tight market will rise, should that be a violation?

- The Commission encourages commenters, in addressing any of the foregoing practices, to discuss whether, and if so how, a Section 811 rule should account for the fact that the practice is used prior to, during, or in the aftermath of a natural disaster, such as an earthquake or a hurricane.

V. Questions Arising From Two Case Studies

This part of the Advance Notice of Proposed Rulemaking focuses on two separate series of events that are frequently cited as examples of possible manipulation in energy markets.

A. BP Amoco/Atlantic Richfield, FTC Docket No. C-3938

In *BP Amoco/Atlantic Richfield*, the Commission issued a consent order that remedied the anticompetitive effects of the proposed $27 billion merger between BP Amoco p.l.c. (BP) and Atlantic Richfield Company (ARCO).[62] Under the terms of the settlement, BP was required to divest, among other things, all of ARCO's assets relating to oil production on Alaska's North Slope (ANS) to Phillips Petroleum Company (Phillips). The divestitures required by the consent order fully resolved the competitive concerns that initially led the Commission to seek a preliminary injunction to block the transaction. By requiring the divestiture of all of ARCO's operations in Alaska, the Commission ensured that BP's market share in the exploration,

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[62] *In the Matter of BP Amoco p.l.c. and Atlantic Richfield Company, FTC File No. 9910192, Docket No. C-3938* (August 25, 2000) (hereinafter BP Amoco/ARCO).

production and transportation of ANS crude oil would remain unchanged, and that the number of players would remain the same.

The divestiture itself is not remarkable for purposes of this Rulemaking. However, the Commission had reason to believe that BP occasionally had exported ANS crude oil to the Far East in order to increase spot prices for ANS crude oil on the West Coast, and that BP benefitted from those higher spot prices because of its status as a merchant marketer. Commenters are encouraged to discuss this scenario, whether this type of conduct is likely to recur, whether this type of conduct still occurs (and if so, how frequently), and whether this type of practice can be characterized as a manipulative or deceptive device or contrivance -- in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale -- that should be prohibited by a Section 811 rule. Commenters are also encouraged to address scenarios such as, for example, when a person or entity determines to hold a supply of crude oil or petroleum product off the coast of the United States for five days -- waiting for the price to go up, and thereby shorting the U.S. supply of crude oil or petroleum product -- and then sells the crude oil or petroleum product after the price has risen, thereby securing greater revenues than it would have secured if it had simply sold the supply on the first day rather than the fifth.

B. Enron

The substantial disruptions in Western electricity and natural gas markets in 2000 and 2001 are often cited as the product of market manipulation by Enron Corp. and other energy traders, and the Commission is interested in securing comments on the extent to which those disruptions may provide guidance as to what may constitute the use of a manipulative or deceptive device or contrivance, in connection with the purchase or sale of crude oil, gasoline, or

petroleum distillates at wholesale. In May 2001, FERC initiated a staff investigation to determine whether Enron or any other sellers manipulated electricity and natural gas markets in California and other Western states in 2000 and 2001. In a Final Staff Report issued in March 2003, the FERC staff found "significant market manipulation," but also determined that

> significant supply shortfalls and a fatally flawed market design were the root causes of the California market meltdown. The underlying supply-demand imbalance and flawed market design greatly facilitated the ability of certain market participants to engage in manipulation.[63]

The staff found in particular that markets for natural gas and electricity in California were inextricably linked; that dysfunctions in each market fed off the other during the crisis; that spot gas prices rose to extraordinary levels, facilitating the unprecedented price increase in the electricity market; and that the dysfunctions in the natural gas market appeared to stem, at least in part, from efforts to manipulate price indices compiled by trade publications.[64] The FERC Staff Report concluded, *inter alia*, that Enron manipulated natural gas markets to the detriment of California electricity consumers.[65]

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[63] *Final Report On Price Manipulation In Western Markets: Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, Docket No. PA02-2-000*, Prepared by the Staff of the Federal Energy Regulatory Commission (March 2003), at ES-1 (hereinafter FERC Staff Report), available at http://www.ferc.gov/industries/electric/indus-act/wec/enron/info-release.asp.

[64] FERC Staff Report at ES-1.

[65] Thereafter, in June 2007, an Administrative Law Judge issued a decision revoking Enron's market-based rate authorization as of January 1997 and ordering it to disgorge $1.6 billion of unjust profits. *See* the initial decision in the *Gaming and Partnership Proceedings* 119 FERC ¶ 63013 (2007), Docket No. EL03-180-000, available at http://www.ferc.gov/industries/electric/indus-act/wec/enron/info-release.asp (hereafter Initial Decision).

The FERC Staff Report provides an extensive discussion of a number of manipulative trading strategies that energy traders used, including two of particular relevance to this Rulemaking proceeding. First, a number of market participants provided false reports of natural gas prices and trade volumes to industry publications, including in particular *Gas Daily* and *Inside FERC*, which the staff characterized as "the most influential and relied-upon compilers of natural gas price indices."[66] The staff found that "the false reporting included fabricating trades, inflating the volume of trades, omitting trades, and adjusting the price of trades."[67] The staff further found that:

> [t]he predominant motives for reporting false information were to influence reported gas prices, to enhance the value of financial positions or purchase obligations, and to increase reported volumes to attract participants by creating the impression of more liquid markets. Market participants that sold power in California, or that were affiliated with such sellers, also had incentives to manipulate reported prices because the clearing price set for power was based, in part, on natural gas spot prices.[68]

Second, the staff found that Enron used its subsidiary, EnronOnline (EOL), to carry out several different types of manipulation. The staff found that certain characteristics -- including in particular the fact that Enron served as the counterparty to every trade on EOL -- made the system ripe for abuse, and permitted Enron to use EOL to effect a number of different types of manipulation. In particular, the staff found that wash trades -- in which two parties would prearrange a pair of sales of the same product with no net change in ownership -- were common on EOL. The parties effected such "trades" in order artificially to influence the closing price on

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[66] *Id*. at ES-6.

[67] *Id.*

[68] *Id.*

EOL, and/or to increase the apparent volume of trading in order deceptively to make the market for that product appear to be more liquid than was actually the case. The staff further found that EOL itself "often posted its willingness to buy and sell at the same price;" that Enron also manipulated prices on EOL "by having affiliates on both sides of certain wash-like trades;" and that these practices both created a false sense of liquidity and raised or otherwise distorted prices.[69] The staff also found that EOL gave Enron a huge information advantage -- derived from its central position in the physical markets -- which enabled it to earn more than $500 million in 2000 and 2001 from its financial products, while sustaining trading losses at a much lower level in the "thinner physical markets."[70]

Four important characteristics of the markets for the physical products -- that is, for electricity and natural gas -- facilitated execution of the foregoing strategies. First, electricity cannot economically be stored more than a few seconds. As a result, electricity generation and transmission are necessarily "just-in-time" activities. Because storing electricity is prohibitively expensive, electricity suppliers must essentially anticipate demand on a minute-by-minute basis, and errant forecasts can cause the system to become unstable and lead to blackouts. Moreover, the absence of storage capability may make physical withholding more attractive to a supplier -- because closing a plant or generation unit will then result in the immediate withdrawal of output from the market -- and unless such a reduction is offset by a competing supplier, this output reduction might be sufficient to produce an increase in price levels.

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[69] *Id*. at ES-11-12.

[70] *Id*. at ES-12.

Second, electricity suppliers may be able to increase profits by withholding capacity during peak demand periods because other rival facilities are already committed to production and cannot respond. Third, the regulation of wholesale electricity markets generates an enormous amount of publicly available information. In particular, the cost structure of electricity generators is publicly available, and this information may potentially support the exercise of market power. And fourth, electric utilities -- including in particular those in the California market -- have relied upon purchasing electricity on spot markets, rather than through the negotiation of long-term contracts, and that type of reliance may facilitate the exercise of market power by placing electricity suppliers in a repetitive situation that supports signaling.

The Commission encourages commenters to consider the foregoing discussion, and to address in particular whether any of the types of manipulative strategies used in the electricity and natural gas markets might be used in the markets for crude oil, gasoline, and petroleum distillates.

C. Questions For Commenters Relating to Case Studies

- Prior to 1995, Congress had imposed a ban on exports of Alaska North Slope crude oil. In 1995, Congress repealed that ban, but also granted the President the power to reimpose the export ban in certain circumstances. The Commission seeks comment on the effects of the export ban and of its repeal; on the residual authority of the President to reimpose the ban; and on any implications these circumstances may have for a Section 811 rule.
- Consider the following scenario: a supplier provides a particular type or formulation of product that cannot be obtained from other suppliers (not due to monopolization by the supplier). This particular product is needed in certain areas, and is not easily substituted

for by other suppliers' products. The Commission seeks comment on whether the following practice would constitute a manipulative device or contrivance: if the supplier sold some of its product to certain areas but not to other areas, at a loss or for a profit that is not as great as it would likely have made in the area where it did not sell. In answering this question, commenters are encouraged to address whether their answers depend on the supplier's knowledge or motivation(s), such as that the supplier (1) might have had contractual arrangements elsewhere; (2) might have anticipated developing more business elsewhere; (3) might have anticipated that prices in the particular areas might go up, making the rest of its supply sold in those areas more profitable; or (4) might have taken the foregoing steps for the express purpose of causing the prices in those areas to go up. Commenters are also encouraged to address whether their answers depend on how difficult it is to substitute for or do without the product, and, if so, what constitutes an unreasonable degree of difficulty.

- As noted above, market manipulation by certain firms (Enron and others) is often cited as a significant cause of the substantial disruptions in Western electricity and natural gas markets in 2000 and 2001. The Commission seeks comment on the extent to which such activities, including but not limited to the activities described above, may provide guidance as to what may constitute the use of a manipulative or deceptive device or contrivance, in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale.
- In light of the electricity market characteristics identified by the FERC Staff Report, and the physical peculiarities of electricity storage and distribution, the Commission seeks

comment on how relevant this experience may be to wholesale petroleum markets, and on whether (and if so to what extent) this experience can inform the Commission's approach to distinguishing manipulative or deceptive devices or contrivances from legitimate business practices.

VI. Regulatory Flexibility Act

- Does Subtitle B of the EISA impose any disparate impact on small businesses? If so, how may this disparate impact be minimized?
- Describe and, where feasible, estimate the number of small entities to which Subtitle B applies.

VII. Conclusion

The Commission will proceed from this ANPR to a Notice of Proposed Rulemaking. The evaluation of comments submitted in response to this ANPR will comprise part of the Commission's rulemaking process.

By direction of the Commission.

Donald S. Clark
Secretary