Before the
FEDERAL TRADE COMMISSION
Washington, D.C.

In the Matter of)
)
Market Manipulation Rulemaking) **No. P082900**
)

COMMENTS OF THE CALIFORNIA ATTORNEY GENERAL

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The Attorney General of the State of California files this comment in support of the Rule proposed by the Federal Trade Commission ("FTC") to implement Section 811 of Title B of the Energy Independence and Security Act ("EISA"). Having conducted numerous gas pricing investigations both in conjunction with the FTC and on its own behalf, this Office deems it appropriate to respond to the FTC's invitation and file a comment reflecting our own experience and expertise. The Attorney General therefore does not propose to critique the Rule in its entirety, but does support the proposed Rule and the underlying rationale therefor provided by the FTC. The portions of the Rule of particular interest to the State of California are discussed below.

The Proposed Rule

The actual rule and its subdivisions are set forth at pages 69-71 of the FTC's Notice of Rulemaking, and we will not repeat them in this comment. Rather, we will only address the specific interpretive principles that have been at issue throughout the discussion of the implementation of Section 811, beginning with the comments proffered in response to the FTC's Advance Notice of Proposed Rulemaking.

The heart of the proposed rule lies in Section 317.3, which basically forbids any person who is directly or indirectly connected with the sale at wholesale of crude oil or any petroleum product from using any means to defraud; from misstating or omitting any material fact that might render a statement as a whole misleading; or from engaging in any business practice that may operate as a fraud or deceit on any person. The reasons underlying our support for this rule, and for the interpretive gloss laid upon it by the FTC in its Notice of Rulemaking ("NOR"), are set forth below.

A. Scienter

Under the standard proposed in the NOR by the FTC, the appropriate scienter for finding a violation of Rule 317.3 would be a mental state "embracing intent to deceive, manipulate, or defraud.[1] The necessary scienter would include recklessness, narrowly defined to encompass conduct driven by a "highly unreasonable [act or] omission, involving not merely simple, or even excusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[2]

The Attorney General supports this definition which is consistent with that applied in cases decided under the Securities Exchange Act of 1934 ("SEA") Section 10(b) and Rule 10(b)-5, as well as analogous rules adopted by the Federal Energy Regulatory Commission ("FERC"). We do not think the scienter standard urged by industry commentators would go far enough because it would require an actual intent to cause harm, and thus would not include reckless

[1] NOR at p. 46 nn.126-128 and accompanying text.

[2] NOR at p. 47; *see also* pp.46-48 nn.126-132 and accompanying text.

conduct even if it had extremely detrimental effects.

B. Causation

In its remarks supporting Proposed Rule 317.3, the FTC has indicated that harm to the oil and gas market should be inferred whenever there is a violation of this rule. Several commentators who responded to the Advance Notice of Rulemaking ("ANPR") expressed the opinion that, in order to establish a claim for relief, a nexus must be shown between conduct forbidden by Rule 317.3 and a direct effect on commodity prices.[3]

From our experience in numerous gas pricing investigations, the Attorney General has come to recognize the near impossibility of linking a particular fraudulent or manipulative act to a corresponding direct effect on price. There are simply too many other variables affecting market activity to prove a causal link between one act of deceptive conduct and a change in market price. The Attorney General therefore agrees with the FTC that as there can be no justification for fraud or deception in an exchange economy, harm to the market should be inferred.[4]

C. Safe Harbors and Exclusions

Numerous organizational commentators have argued that the Rule should include a "safe harbor provision or other exemption" to avoid an overlap with the Commodity Futures Trading Commission ("CFTC")'s claimed exclusive jurisdiction under the CEA. That is, they suggest that the FTC should not assert authority over matters regulated by the CFTC or otherwise subject to a specified exemption from CFTC jurisdiction. Our Office supports the FTC's decision not to include such a provision or exemption.

We object to implementation of a "safe harbor" to avoid overlap with the CFTC's regulatory jurisdiction for several reasons. First, a "safe harbor" provision would be inappropriate because it could exempt from FTC authority entities and transactions that are by no means either insignificant or otherwise adequately subject to regulatory scrutiny. Such a provision would undermine a major point of the EISA, which was to provide the FTC with the power to monitor for and prevent fraud and deceit in the commodity futures market , insofar as it affects oil and gas futures. The Attorney General supports vigorous enforcement efforts of the type that the FTC has displayed in the cases which we have prosecuted together in the past.

[3] *See, e.g.,* American Petroleum Institute Comment at p. 31.

[4] NOR at p. 50.

Second, shackling the FTC with the restrictions placed upon CFTC authority would severely limit the jurisdiction of the FTC. An example is provided by the so-called Enron Loophole.[5] This loophole, part of the Commodity Futures Modernization Act of 2000 (CFMA"), allows energy commodities such as crude oil futures traded in a deregulated environment to be exempt from CFTC regulation. In one example, the CFTC has formerly found trades on the Intercontinental Exchange to be within this loophole and thus exempt from CFTC oversight.[6] By its terms, however, the CFMA is applicable *only* to the CFTC. Thus, the FTC, enforcing the legislative mandate afforded it pursuant to EISA, should not be bound to recognize the Enron Loophole and should be free to enforce the EISA's mandate against the use of fraud, deceit or manipulation in connection with the sale at wholesale of oil and gas, including oil and gas futures.

Of equal concern is the fact that the CFTC has through administrative action chosen to exempt from full U.S. regulation transactions conducted through a "foreign Board of Trade." In a practice strongly reminiscent of the Enron Loophole, the CFTC staff issues a no-action letter exempting trades from CFTC scrutiny when they take place on foreign exchanges with U.S. terminals, and *when* the foreign exchange theoretically offers an equivalent regulatory format to that of the CFTC. Leading examples are the Dubai Mercantile Exchange, an entity regulated by the Dubai Financial Services Authority,[7] and, in a change from prior practice, the Intercontinental Exchange, which is considered a U.K entity although it maintains a U.S. headquarters and trading infrastructure. The Intercontinental Exchange is regulated by the Financial Services Administration of the U.K.

The practical effect of these loopholes and exemptions has been identified in two reports published by a subcommittee of the United States Senate that together indicate that "trading on the [Intercontinental Exchange] has been used to manipulate or excessively speculate in U.S. delivered crude oil and natural gas contracts."[8] Recognizing the FTC's separate authority, although it may overlap with that granted to the CFTC, would help to ensure vigorous prosecution of fraudulent manipulation of wholesale oil and gas futures which has been lacking in the past.

[5] *See, e,g.,* Greenberger at pp. 3-5. (The citation to Greenberger, as to others cited in this simplified format, refers to the comment filed by the author in response to the ANPR.)

[6] *Id.* at 2. This exemption was particularly questionable as the Intercontinental Exchange, which, while characterized as by CFTC staff as a "U.K. entity" not subject to direct CFTC regulation, maintains a U.S. headquarters and trading infrastructure, on which roughly 30% of West Texas Intermediate futures are bought and sold. *Id.*. at pp. 2-3.

[7] *Id.* at pp.5-6, 13-14.

[8] Greenberger at p.8 nn.32-33 and accompanying text, citing Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, THE ROLE OF MARKET SPECULATION IN RISING OIL AND GAS PRICES: A NEED TO PUT A COP BACK ON THE BEAT (June 27, 2006); Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET (June 27, 2006).

Review of comments made by Senators integrally involved in the passage of the EISA show that they were supportive of a strong role for enforcement of the Act by the FTC, even to the extent that FTC jurisdiction and enforcement might overlap that of the CFTC, or other federal agencies. In a letter to the FTC dated April 8, 2008, Senator Cantwell cited the use by FERC of a grant of similar authority under the Energy Policy Act of 2005 as a model for rulemaking by the FTC that could be used to "aggressively implement the [FTC's] new responsibility to prohibit oil and petroleum market manipulation" under EISA.[9] Moreover, she has encouraged the revocation of no action letters issued to foreign Boards of Trade.[10]

In sum, the intent of Congress in enacting the EISA was to confer coequal and overlapping authority to the FTC over the manipulation of wholesale gas and oil futures. A safe harbor provision exempting transactions and entities from the authority of the FTC because they are also within the jurisdiction of the CFTC would be inconsistent with the intent.

Conclusion

The FTC has proposed a rule that in broad terms forbids any person to employ - directly or indirectly - fraud, deceit or manipulation in connection with the sale of crude oil or petroleum products at wholesale. The rule confers upon the FTC the regulatory authority it needs to address market manipulation that has heretofore been ignored or swept under the rug. It has our support.

9 Letter from Senator Maria Cantwell to the FTC 4/0808.

10 *See* Nick Snow, *Senate to FTC, CFTC: Police Markets More Aggressively*, OIL & GAS JOURNAL, June 9, 2008 AT 37:

> "Cantwell will press both the Federal Trade Commission .... and the [CFTC] to regulate oil and commodity markets more aggressively, Cantwell said following the June 3 [2008] Commerce, Science and Transportation Committee hearing, which she chaired.
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> "[Cantwell] intends to continue pressuring CFTC to revoke 'no action' letters issued by its staff that allow electronic exchanges operating outside US borders to continue trading West Texas Intermediate crude and related commodities without being directly regulated, Cantwell said. 'Our oil futures markets were substantially deregulated by CFTC staff decisions that were made behind closed doors."