

FTC's Proposed Petroleum Market Manipulation Rule And Market Manipulation Workshop

Washington, DC
November 19, 2008

On November 6, 2008, the Federal Trade Commission (“FTC”) held a workshop in which its staff examined support for and opposition to a proposed Petroleum Market Manipulation Rule (“Proposed Rule”) designed to prohibit fraud and deception in wholesale petroleum markets. The Proposed Rule was issued by the FTC on August 19, 2008. Written comments regarding the Proposed Rule were due by October 17, 2008. Various industry participants were invited to take part in the workshop. Going forward, the FTC will consider the views expressed at the workshop, along with previously submitted comments, to determine the format and content of a final rule prohibiting market manipulation in the petroleum industry.

Background and Overview

Pursuant to Title VIII, Subtitle B of the Energy Independence and Security Act of 2007 (“EISA”),¹ the FTC has proposed a rule to implement Section 811 of Subtitle B, which prohibits the use of manipulative or deceptive devices or contrivances in wholesale petroleum markets. The Proposed Rule, published in Section 317.3 of the Federal Register, declares it:

“unlawful for any person, directly or indirectly, in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale,

- (a) to use or 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 light of the circumstances under which they were made, not misleading; or

¹ Pub. L. No. 110-140, 121 Stat. 1723 (Dec. 19, 2007), Title VIII, Subtitle B. *codified* at 42 U.S.C. §§ 17301-17305.

- (c) to engage in any act, practice or course of business that operates or would operate as a fraud or deceit on any person.”²

The FTC would enforce the Proposed Rule when an entity or person, acting with scienter, engages in any of the above listed conduct in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale. In its current form, fraudulent statements, material omissions, and other conduct that operates as a fraud or deceit would violate the Proposed Rule. For example, false reporting to private data reporting services or misleading announcements by refineries, pipelines, or investment banks done with the requisite scienter in connection with the purchase or sale of a covered product at wholesale, would be subject to an enforcement action under the Proposed Rule.

Topics Discussed at FTC Workshop

1. Scope of certain definitions. The Proposed Rule defines “wholesale” as purchases or sales at the terminal rack or upstream of the terminal rack, excluding retail gasoline sales to consumers. Workshop participants and other commenters argued that the definition should exclude transactions at the terminal rack because little evidence exists to suggest that transactions at this level were threatened by any potential manipulative influence. Despite these views, the FTC expressed continued support for a rule that applies to such transactions and the final version of the Proposed Rule will likely include sales at the terminal rack.

Some workshop participants also expressed concern over the FTC’s intention to extend the Proposed Rule to cover non-petroleum products used in blending gasoline, specifically ethanol. Although ethanol is not explicitly included in the definition of gasoline, the FTC representatives stated that manipulative or deceptive conduct involving non-petroleum based commodities can directly or indirectly affect the price of gasoline. Thus, manipulation of ethanol prices that affects prices directly or indirectly in the wholesale gasoline market could be the subject of enforcement.

2. Securities law model for the Proposed Rule. Because, in the FTC’s view, EISA’s language is closely modeled after the 1934 Securities and Exchange Act, the FTC based the Proposed Rule on the Securities and Exchange Commission’s (“SEC”) Rule 10b-5.³ Rule 10b-5 prohibits the use of any manipulative or deceptive device or contrivance in contravention of SEC rules. According to the FTC, modeling the Proposed Rule on an

² Market Manipulation Rule § 317.3. 70 Fed. Reg. 48326 (proposed Aug. 19, 2008), *available at* <http://www.ftc.gov/os/2008/08/P082900nprm.pdf>.

³ 17 C.F.R. § 240.10b-5 (2008).

existing anti-fraud market manipulation regulatory scheme will reduce uncertainty and assure greater compliance with the new rule.

Many speakers at the workshop commented on issues raised by the significant differences between the highly regulated securities market and the comparatively unregulated petroleum wholesale market. The FTC noted that it does not plan to simply adopt the entirety of the securities law regulatory approach. One major concern expressed at the workshop was that importing the SEC's requirement of full disclosure could chill petroleum market participants' incentives to acquire and use confidential and proprietary market data for their own profit. Workshop participants also expressed concern that refiners trying to ensure full compliance with the Proposed Rule may accidentally disclose competitively sensitive information with competitors, a practice prohibited by the antitrust laws. The FTC anticipated these concerns and stated that the Proposed Rule does not in any way impose affirmative duties to disclose proprietary information. In addition, the FTC made clear that companies have no affirmative duty to supply or provide access to terminals or pipelines. However, without providing any specific examples, the FTC refused to entirely foreclose the possibility that a decision to withhold supply or access might, under certain circumstances, violate the Proposed Rule. Thus, a degree of uncertainty remains regarding which actions might violate the Proposed Rule.

Like Rule 10b-5, the Proposed Rule also has a scienter requirement. The Proposed Rule requires a mental state "embracing intent to deceive, manipulate, or defraud." The FTC stated that a showing of recklessness, as opposed to a showing of specific intent, will satisfy the scienter element under the Proposed Rule. Although some commenters expressed concern regarding the breadth of a recklessness standard, the FTC noted that this standard is consistent with the legal and regulatory precedents governing Rule 10b-5. Thus, a final version of the rule will likely include a recklessness standard.

3. Prohibited conduct under the Proposed Rule. The Proposed Rule prohibits actual fraud that is intended to manipulate wholesale petroleum markets. It also prohibits persons or entities from misrepresenting, and in some instances omitting, material information in connection with wholesale petroleum transactions. As established in securities law, a fact is material if there is a substantial likelihood that a reasonable market participant would consider it in making its decision to transact. The reporting of material false or misleading information to important government agencies, to third-party reporting services, or to the public through corporate announcements would all be considered misrepresentations of material fact under the Proposed Rule.

Further, while there is no general duty to disclose information, a material omission could occur if, for example, an entity or person provides information but fails to disclose a material fact, the omission of which makes such information misleading. Workshop participants expressed concerns that imposing liability for omissions, especially when

combined with a recklessness scienter standard, risked chilling firms' incentives to gather data and could result in anticompetitive information exchanges and disclosures. Other commenters noted that partial information disclosures are part of the ordinary bargaining process in wholesale petroleum markets and that a rule imposing liability for these "incomplete" statements could ultimately increase prices to consumers.

4. Lack of requirement of market or price effect. The Proposed Rule does not require proof of an impact on price or the market generally. Under the FTC's interpretation, the Proposed Rule would be violated when a person or entity uses or employs a manipulative or deceptive device or contrivance, regardless of whether those actions can be shown to result in tangible price or market effects. Furthermore, the FTC argues that harm to the market can be inferred from fraud or deception because there are no reasonable economic justifications for such behavior. Some workshop participants expressed concern that the absence of a price effects requirement would result in the Proposed Rule reaching beyond market manipulation to general fraud.

5. The Proposed Rule's interaction with other federal rules prohibiting market manipulation. Section 813 of EISA makes explicit that the FTC's jurisdiction to enforce the Proposed Rule matches the scope of its jurisdiction under the FTC Act. Some workshop participants argued that this jurisdiction conflicts with enforcement rights given to the Commodities Future Trading Commission ("CFTC") and the Federal Energy Regulatory Commission ("FERC"). The CFTC argued that the Proposed Rule intrudes on its exclusive jurisdiction over future trading activities pursuant to the Commodities Exchange Act ("CEA"). The FTC, however, interprets the CEA to give the CFTC exclusive authority only over the futures contracts themselves, for example with respect to agreements or transactions involving such contracts. It does not interpret the CEA to give the CFTC exclusive authority over *manipulation* of futures markets, which the FTC concludes is separate from the CFTC's authority to regulate futures contracts. Other industry participants argued that the Proposed Rule should not extend to FERC's existing regulation of pipelines. However, the FTC interprets the FTC Act to also give it jurisdiction over oil and gas pipelines and therefore believes that pipelines are subject to the Proposed Rule.

6. Private cause of action. The Proposed Rule does not directly address the existence of an implied private right of action. Commenters and workshop participants argue that absent some clarity, plaintiffs will assert claims, which could result in years of litigation as the federal courts resolve the issue. Workshop participants urged the FTC to squarely address this issue in a final rule.

7. Penalties for violating the Proposed Rule. Section 814 of EISA, the authorizing statute, provides that any penalties applicable under the FTC Act apply with equal force to violations of the Proposed Rule. Such penalties are civil in nature and include fines for each violation or, if a court action is brought, mandatory injunctions or other

equitable relief deemed appropriate. In addition, any violation of the Proposed Rule is also punishable by a civil penalty of not more than \$1,000,000. Further, each day of a continuing violation is considered a separate violation.

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If you have any questions, please contact George S. Cary, David I. Gelfand, or Jeremy Calsyn in the Firm's Washington Office at 1-202-974-1500 or Brian Byrne in the Firm's Brussels Office at 011-322-287-2000.

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