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Prohibitions on Energy Market Manipulation: The FTC Issues Its Final Rule

On August 6, 2009, the Federal Trade Commission, pursuant to Section 811 of the Energy Independence and Security Act of 2007 ("EISA"), issued its final Rule prohibiting fraudulent and deceptive conduct, including misleading statements, in connection with the wholesale market for petroleum products.[1] The Rule will go into effect on November 4, 2009, and will be enforced by the FTC. Modeled on the antifraud provisions of the SEC's Rule 10b-5, which prohibits similar actions in connection with the sale or purchase of any security, the Rule is intended to achieve the "appropriate balance between the flexibility needed to prohibit fraud-based market manipulation without burdening legitimate business activity."

Prohibited conduct is set forth in Section 317.3 of the Rule, which includes two sections, each with its own "explicit and tailored scienter standard" that is intended to prohibit undesirable conduct while avoiding chilling desirable economic activity.

Section 317.3(a) makes it unlawful for any person to:

> Knowingly engage in any act, practices or course of business — including the making of any untrue statement of material fact — that operates or would operate as a fraud or deceit upon any person.

This broad prohibition permits the FTC to "reach all types of fraudulent or deceptive conduct likely to harm wholesale petroleum markets."

Section 317.3(b) makes it unlawful for any person to:

> Intentionally fail to state a material fact that under the circumstances renders a statement made by such person misleading, provided that such omission distorts or is likely to distort market conditions for any such product.

Despite the absence of any existing disclosure obligations in the wholesale petroleum markets, the FTC decided to include a separate prohibition on material omissions because such omissions could serve as a vehicle to manipulate these markets.

Penalties

As set forth in Section 813 of the EISA, violations are punishable by a civil penalty of up to $1 million in addition to any penalty that may be applicable under the FTC Act.[2] Each day of a continuing violation is considered to be a separate violation.

Private Right of Action

By relying on the text and judicial construction of SEC Rule 10b-5 as well as securities law precedent, the FTC may have set a favorable framework for courts to find a private right of action under the Rule. During the notice and comment rulemaking proceedings, commentators urged the FTC to clarify that the Rule would not create or imply a private right of action. In response, the FTC noted that the EISA did not expressly create a private right of action but stated that whether such a right might be implied was a question for Congress or the courts to resolve.

Duties

Unlike the securities law on which it is modeled, the Rule does not expressly impose nor does the FTC intend to impose specific conduct or duty requirements such as a duty to supply product, a duty to provide access to pipelines or terminals, a duty to disclose, or a duty to update or correct information. In particular, the Rule does not require the disclosure of price, volume and other data to individual market participants or the market at large. The Rule imposes no recordkeeping requirements.

Section 317.3(a): "Knowingly"

During the rulemaking proceedings, the scienter requirement of this provision was the subject of many comments. Many commentators argued that the final Rule should require a specific intent to manipulate the market because market participants make decisions in real time and such a standard "would considerably reduce the element of subjectivity and uncertainty."[3] Instead, the FTC chose an "extreme recklessness" standard as articulated by the U.S. Court of Appeals for the Seventh Circuit in *SEC v. Lyttle*,[4] because overt fraudulent or deceptive acts "can have no beneficial effect in any setting." This standard requires a showing that the actor "knew or must have known that his conduct created a danger of misleading buyers or sellers." In the final Rule, the FTC deleted the phrase "with actual or constructive knowledge" to clarify that inadvertent mistakes would not be actionable as manipulation. Instead, the phrase "must have known" encompasses conduct that presents a danger of market manipulation "so obvious that the actor must have been aware of it." Thus, to violate this section of the Rule, a person must engage in prohibited conduct "knowing" that it is fraudulent or deceptive.

> For example, a trader's state of mind must encompass more than just carrying out the ministerial function of transmitting false information to a price reporting service. Rather, there must be evidence that the trader knew or must have known that the information transmitted was false.[5]

Although the FTC does not intend that the requisite state of mind be imputed across persons within an organization, the FTC noted that the scienter element would also be satisfied if the trader acted at the direction of another who "knew or must have known" the transmitted information was false.

Finally, no showing of a departure from "ordinary care" is required. Although the Seventh Circuit's standard includes this element as a means to establish scienter, the FTC concluded that such a showing is not required because the standards of ordinary care in the context of wholesale petroleum markets are less well defined than those developed in the context of the securities markets.

Specific examples of conduct violating this section include false public announcements regarding pricing or output, false statistical or data reporting, false statements in bilateral communications that result in the dissemination of false information to the broader market, and deceptive conduct such as wash sales, which are intended to disguise the liquidity of a market or the price of a product. Absent dissemination to the broader market, the FTC does not intend this section to reach fraud or deception in bilateral negotiations.

Materiality

Guided by securities law precedent, the FTC adopted a materiality standard that treats a fact as material if there is a "substantial likelihood that a reasonable market participant would consider it important in making a decision to transact because the material fact significantly altered the total mix of information available." The standard for materiality is the same for both Sections 317.3(a) and (b).

Section 317.3(b): "Intentionally"

To violate this section, a person must intentionally omit information from a statement with the further intent to make the statement misleading, "rather than simply being aware of the potential risk posed by his or her conduct." Note that this standard does not require the actor to intend to manipulate the market.

Section 317.3(b) does not impose an affirmative duty to disclose or update information. Therefore, this section applies only when a person makes a voluntary statement or is compelled to do so by statute, order or regulation. Businesses are not required to disclose commercially sensitive information to any other person, unless there is a pre-existing legal obligation to do so, and may withhold market intelligence gathered about market conditions. Failure to provide such information does not violate this section, even if a counterparty in commercial negotiations would have acted differently had the information been revealed.

Section 317.3(b): Limiting Proviso

Commentators expressed concerns that specifically prohibiting material omissions would unduly deter voluntary disclosures of information. The FTC addressed these concerns by requiring that an omission distort or be likely to distort market conditions for a covered product. This proviso is intended to assure businesses that omissions occurring in the context of routine business activity are not actionable unless such omissions undermine the integrity of market information. Significantly, proof of a specific price effect is not required because the proviso "speaks only to the ability of market participants to rely on the integrity of market data in making purchase and sales decisions."

Broad Reach

The Rule's reach is established by the definitions contained in Section 317.2 and in the preamble to the prohibited conduct provisions of Section 317.3. In this regard, the FTC broadly interpreted the EISA and used the phrases "directly or indirectly" and "in connection with" that are in Section 317.3's preamble to provide itself with "sufficient flexibility" to reach persons outside the scope of the FTC Act and products not identified in the EISA.[6] The result is a Rule that is expansive in scope. Specifically, Section 317.3's preamble states that:

> It shall be unlawful for any person, directly or indirectly, in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale, to…

Person

Section 317.2(d) defines "person" to mean "any individual, group, unincorporated association, limited or general partnership, corporation, or other business group." Additionally, certain pipeline companies or their affiliates may fall within the scope of the Rule if they are involved in the purchase or sale of petroleum products and not just the provision of transportation services. To reach this conclusion, the FTC relied on the "in connection with" language contained in the preamble of Section 317.3. Similarly, the FTC decided not to adopt a blanket safe harbor for persons involved in futures market transactions, despite the Commodity Futures Trading Commission's jurisdiction in this area.

Liability may also be imposed on persons who indirectly engage in market manipulation. According to the FTC, the phrase "directly or indirectly" in Section 317.3's preamble denotes the level of involvement necessary to establish liability. Therefore, the Rule applies to persons directly engaged in prohibited conduct and those that do so indirectly through the actions of others.

Significantly, although the FTC "does not intend to regulate or second-guess market participants' legitimate supply and operational decision-making," persons making these decisions may also be liable if there is a sufficient nexus between the conduct at issue and the wholesale petroleum markets. Again, the phrase "in connection with" was construed broadly to reach this level of operational scrutiny.

Crude Oil

Briefly, the Rule defines "Crude Oil" as liquid crude oil and any mixture of hydrocarbons that can be processed into refinery feedstock, but excludes natural gas, natural gas liquids and noncrude refinery feedstocks.

Gasoline

Here, the FTC intended to capture in its definition finished gasoline products and those products requiring only oxygenate blending to be finished. The FTC declined to extend the definition to include renewable fuels and blending components, because these products were not listed in the EISA. Nonetheless, the FTC concluded that it may apply the Rule to conduct associated with these products if appropriate under its interpretation of "in connection with."

Petroleum Distillates

The FTC's definition includes "finished fuel products, other than gasoline, produced at a refinery or blended in a tank at a terminal," including on-road diesel, heating oil and kerosene-based jet fuels, but excluding heavy fuel oils. Additionally, the definition may also include renewable fuels such as biodiesel under the FTC's interpretation of the phrase "in connection with."

Wholesale

Finally, the purchase or sale of a covered product must be "at wholesale." Here, the FTC intends to include "all bulk sales of crude oil and jet fuel (even when not for resale) and all terminal rack sales," but not retail sales of gasoline or diesel fuels to consumers. In its comments to the proposed Rule, the Society of Independent Gasoline Marketers of America argued that, to date, there have been no reported instances of price manipulation at the terminal rack level and that including rack sales in the definition may lead to unintended consequences. The FTC, however, declined to remove rack sales from the definition because prohibitive conduct may in fact occur at the terminal rack level, and, because such sales are technically "wholesale," excluding them would place the Rule at odds with the express language of the EISA.

Conclusion

Through the final Rule, the FTC has constructed an expansive enforcement authority with the "flexibility needed to prohibit fraud-based market manipulation." Much less uncertain is whether the Rule will do so "without burdening legitimate business activity." Foremost among commentators' concerns was whether the "tailored" scienter standards for prohibited conduct would chill economic activity and voluntary disclosures of information. It is also worth noting that Commission Kovacic had this same concern and voted "no" on the final Rule. Additionally, the FTC has created a situation in which pipeline companies, producers of renewable fuels, and persons making operational and supply decisions will have to second guess whether there is a sufficient nexus between their actions and the wholesale markets. Together, and given the size of the penalty, legitimate business activity will necessarily be burdened. The question that remains is whether the FTC has struck the "appropriate balance."

The full text of the final Rule may be found at http://www.ftc.gov/opa/2009/08/mmr.shtm. Please feel free to contact us if you have any questions or if you would like assistance pertaining to this Rule.

Endnotes

[1] 16 C.F.R. § 317 (2009).

[2] 15 U.S.C. § 41 *et. seq*.

[3] *Comments of the American Petroleum Institute and the National Petrochemical Refiners Association in Response to Revised Notice of Proposed Rulemaking*, May 29, 2009, at 32-34. Public comments and other filings pertaining to the proposed rule can be found at http://www.ftc.gov/os/comments/marketmanipulation3/index.shtm.

[4] 583 F.3d 601, 603 (7th Cir. 2008).

[5] Federal Trade Commission, Prohibitions on Market Manipulation in Subtitle B of Title VIII of The Energy Independence and Security Act, Statement of Basis and Purpose (Aug. 6, 2009).

[6] "Thus the final Rule reaches market manipulation that occurs in the wholesale purchase or sale of products covered by Section 811 (and defined in the Rule) — and in connection with such purchases or sales — provided that there is a sufficient nexus between the prohibited conduct and the market for these products."