PROHIBITING FRAUD AND DECEPTION IN WHOLESALE PETROLEUM MARKETS: THE NEW FEDERAL TRADE COMMISSION MARKET MANIPULATION RULE

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Synopsis: A number of regulatory agencies have long enforced prohibitions against manipulative behavior in the markets that they oversee. The Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Commodities Futures Trading Commission all have statutes or rules that ban manipulation. Recently, Congress granted authority to the Federal Trade Commission to promulgate a rule against market manipulation in wholesale petroleum markets, which it did in November 2009. Unlike the other agencies, the FTC is not a sector regulator; it is a law enforcement agency that enforces the antitrust and consumer protection laws across all industries. The Commission's new rule thus breaks new ground both for the agency and for entities that trade in covered products. A thorough understanding of the rule is necessary to comply with its strictures without diluting the incentives to engage in efficient business conduct. This article aids in that understanding by discussing the authorizing legislation, the rulemaking process, the breadth and scope of the final rule, the FTC's reasons for adopting the rule that it did, and the rule's place in the regulatory landscape facing companies in wholesale petroleum markets.

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I. INTRODUCTION

After a long period of relatively stable prices, U.S. retail gasoline prices experienced sharp increases beginning in 2005. By 2006, the average price for regular gasoline reached \$2.59 per gallon, and by May 2007 it had risen to \$3.13.[1] A number of observers attributed at least some part of the higher prices to market distortions caused by fraudulent or manipulative conduct in wholesale and futures markets.[2] In response, Congress added language to a comprehensive energy reform bill, the Energy Independence and Security Act of 2007 (EISA),[3] that authorized the Federal Trade Commission (FTC or Commission) to promulgate regulations to define and prohibit manipulative or deceptive conduct in wholesale petroleum markets.[4] The Commission conducted a rulemaking proceeding under the Administrative Procedure Act (APA),[5] which included receiving comments from interested parties and holding a workshop on alternative potential rules, and promulgated a rule that took effect on November 4, 2009.[6] The final rule states that:

> [i]t 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:

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1. United States Energy Information Administration (EIA) *Motor Gasoline Retail Prices, U.S. City Average,* MONTHLY ENERGY REVIEW, July 2009, at Tbl. 9.4 (unleaded regular gasoline, U.S. City average retail price (nominal cents per gallon, including taxes)).

2. *See, e.g.,* Michael Greenberger, Testimony before the U.S. Senate Committee on Commerce on Science & Transportation, Energy Market Manipulation and Federal Enforcement Regimes 2 (June 3, 2008) (futures markets subject to price manipulation); Mark Cooper, Dir. Of Resources, Consumer Federation of America, Testimony on Energy Market Manipulation and Federal Enforcement Regimes before the Committee on Commerce, Science and Transportation U.S. Senate 1 (June 3, 2008) (manipulation causes gasoline prices to rise above market levels). *See also* Gregory Roberts, *Feds Should Crack Down on Oil Price Gouging, Cantwell Says*, SEATTLE POST-INTELLIGENCER, May 31, 2007, at 1 (Senator Cantwell wants the FTC to have the power to investigate "market manipulation and price gouging by gasoline companies").

3. 42 U.S.C. §§ 17301-17386 (2006); *see also* CARL E. BEHRENS AND CAROL GLOVER, GASOLINE PRICES: LEGISLATION IN THE 110TH CONGRESS, Cong. Research Ser. (May 14, 2008) at CRS-1 (stating that "the main provisions of [EISA] were an increase in the Corporate Average Fuel Economy (CAFE) standards for automobiles and light trucks, and an increase in the requirement for the use of renewable fuels in gasoline").

4. *Id.* at § 17301.

5. 5 U.S.C. § 553 (2006). An APA rulemaking requires public notice of the proposed rule, the right to comment by interested parties, hearings at the discretion of the issuing agency, and publication of a statement of basis and purpose of the final rule.

6. Prohibitions on Market Manipulation, Final Rule, 74 Fed. Reg. 40,686 (Aug. 12, 2009) (to be codified at 16 CFR pt. 317) [hereinafter *Prohibitions on Market Manipulation*].

> (a) Knowingly engage in any act, practice, 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; or
> (b) 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.[7]

The final product of the proceeding is a fraud-based rule that draws heavily from similar rules in effect at the Securities and Exchange Commission (SEC), and the Federal Energy Regulatory Commission (FERC), and the anti-fraud enforcement efforts at the Commodities Futures Trading Commission (CFTC), though modified to reflect the unique features of wholesale petroleum markets.

The market manipulation rule has engendered substantial comment in the antitrust and energy communities.[8] This article is designed to explain in detail the scope and reach of the final rule, and to provide some understanding of the Commission's rationale behind the rule. Section II sets out the rule and discusses the legislative history of the EISA and the earlier statutes and rulemakings that served as the models of this latest rule. Section III discusses the rulemaking process and the derivation of the final rule. Section IV delineates the scope of the rule and explains the Commission's jurisdictional reach. Section V discusses the practices prohibited by the final rule and the elements necessary for the Commission to prove a violation.

II. THE ENERGY INDEPENDENCE AND SECURITY ACT OF 2007 AND ANTECEDENT RULES AND ENFORCEMENT EFFORTS

The EISA was signed into law on December 19, 2007. Subtitle B of Title VIII of the statute addressed the prevention of manipulation of wholesale petroleum markets. Subtitle B contains two substantive provisions: section 811 prohibits any manipulation in wholesale markets that violates a rule or regulation that the Commission may promulgate, and section 812 prohibits the provision of false or misleading information to a federal agency.

Specifically, section 811 makes it unlawful for any person to use or employ "any manipulative or deceptive device or contrivance" in buying or selling in wholesale petroleum markets in violation of any rule the Commission may promulgate.[9] Section 812 prohibits any person from

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7. *Id.* at 40,702.

8. J. Bruce McDonald, *Curbing Wholesale Petroleum Market Manipulation*, LAW360, Aug. 2009, *available at* http://competition.law360.com/print_article/116773; Layne Druse & Amy Garzon, *A Short Guide to the Prosecution of "Market Manipulation" in the Energy Industry: CFTC, FERC, and FTC*, GLOBAL COMPETITION POLICY, July 2008, at 2, *available at* http://www.globalcompetitionpolicy.org; Nick Snow, *FTC's Rule Prohibits Oil Market Manipulation*, OIL & GAS JOURNAL, Aug. 6, 2009, at 1, *available at* http://www.ogj/index/article-display; *FTC Seeks Comments on Revised Petroleum Market Manipulation Rule*, ANTITRUST REVIEW, April 17, 2009, *available at* http://www.antitrustreview.com/archives/date/2009/04; *FTC Proposal Would Bring Oil Futures Under New Antimanipulation Standard*, FUTURES INDUSTRY MAGAZINE, *available at* http://www.futuresindustry.org/fi-magazine-home.asp?a=1268.

9. "It is unlawful for any person, directly or indirectly, to use or employ, in connection with the purchase or sale of crude oil gasoline or petroleum distillates at wholesale, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Federal Trade Commission may

reporting any required information relating to the wholesale prices of petroleum products, including crude oil, to any federal agency if the person "knew, or reasonably should have known, the information to be false or misleading," and intended for the false information to be disseminated into petroleum markets.[10] Section 812 is self-actuating; it does not require a rulemaking in order to take effect.

EISA contains three additional paragraphs that address enforcement, penalties, and the effect of the statute on other laws. Section 813 grants enforcement powers to the Commission "by the same means, and with the same jurisdiction" as the FTC Act, and treats a violation as an unfair or deceptive act or practice.[11] Section 814 makes a violation of 811 or 812 subject to a penalty of not more than $1,000,000 per day per violation, and instructs the court, in determining the appropriate fine, to consider the seriousness of the violation and any efforts to remedy the harm caused by the violation.[12] Section 815 adds an antitrust savings clause and states that the subtitle does not preempt any state law.[13]

EISA is not the first federal statute to prohibit manipulative behavior in specific markets. Congress first acted to prohibit fraud and manipulation in securities markets in the 1930s. Although the legislative history of EISA is sparse – there were no hearings and there are no committee reports – there are indications that Congress intended that any FTC market manipulation rule function in a manner similar to the rules issued first by the SEC, and more recently by the FERC. Chief sponsors of the market manipulation sections of EISA have stated that the "new authority granted to the FTC is modeled on the antimanipulation authorities utilized by other agencies such as the . . . SEC and . . . the FERC."[14] Additionally, the CFTC prohibits market manipulation under

prescribe as necessary or appropriate in the public interest or for the protection of United States citizens." 42 U.S.C. § 17301 (2006) 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). The Commission treated this language as a non-substantive typographical error, and noted that all parts of both sections should be read to cover "crude oil, gasoline, and petroleum distillates." Advanced Notice of Proposed Rulemaking (ANPR), 73 Fed. Reg. 25,614, at 25,621 (May 7, 2008) (to be codified at 16 C.F.R. pt. 317).

10. 42 U.S.C. § 17302 (2006); Section 812 reads in its entirety:

> It is unlawful for any person to report information related to the wholesale price of crude oil gasoline or petroleum distillates to a Federal department or agency if –
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> (1) the person knew, or reasonably should have known, the information to be false or misleading;
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> (2) the information was required by law to be reported; and
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> (3) the person intended the false or misleading data 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.

11. 42 U.S.C. § 17303 (2006).

12. 42 U.S.C. § 17304 (2006); Section 814 penalties are in addition to any other penalties that may be available to the Commission under the Federal Trade Commission Act. Consequently, the Commission could seek redress or disgorgement, among other things, if appropriate.

13. 42 U.S.C § 17305 (2006).

14. Letter from Senators Maria Cantwell, Byron Dorgan, Olympia Snowe, Gordon Smith, and Daniel Inouye to FTC Chairman William Kovacic, and Commissioners Pamela Jones Harbour, Jon Leibowitz, and J. Thomas Rosch, at 1 (April 8, 2008), *available at* http://cantwell.senate.gov/news/recrod.cfm?id=295769+.

its authorizing statutes. The FTC considered all three existing anti-manipulation regimes in the process of crafting its final rule.

A. SEC Rule 10b-5

The phrase "manipulative or deceptive device" first appears in the Securities Exchange Act of 1934.[15] Section 10(b) of that statute prohibits the use of "any manipulative or deceptive device or contrivance in contravention of such rules as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[16] The SEC used the authority granted in the 1934 statute to promulgate a three-part rule, Rule 10b-5, which makes it unlawful for any person:

> To employ any device, scheme, or artifice to defraud;
> 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
> 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.[17]

There is a long line of case law interpreting Rule 10b-5 and its underlying statute.[18] Showing liability under 10b-5 requires establishing that a defendant engaged in "intentional or willful conduct *designed to deceive or defraud* investors by controlling or artificially affecting the price of securities."[19] More specifically, the SEC must show that the defendant: "(1) Made a material misrepresentation or a material omission as to which he had a duty to speak, or used a fraudulent device; (2) with scienter; (3) in connection with the purchase or sale of securities."[20]

The 1934 Act and Rule 10b-5 are not stand-alone efforts to prohibit fraud in securities markets. This anti-fraud provision is merely one part of a comprehensive regulatory scheme that covers all parts of securities markets, including the issuance of initial securities,[21] companies that engage in investing and trading,[22] investment advisors,[23] and corporate accounting fraud.[24]

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15. 15 U.S.C. § 78a (2006).

16. 15 U.S.C. § 78j(b) (2006).

17. 17 C.F.R. § 240.10b-5(a)-(c) (2007).

18. There are several treatises devoted to Section 10b-5. *See, e.g.*, A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD (Shepard's/McGraw-Hill 1967) (1979); THOMAS L. HAZEN, *Treaties on the Law of Securities Regulation*, Vol. 4, PRACTITIONER'S TREATIES SERIES (West 5th ed. 2005); ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 (Clark Boardman Callaghan 2d ed. 1981). *See also,* C. Edward Fletcher, *Learning to Live with the Federal Arbitration Act – Securities Litigation in a Post-McMahon World*, 37 EMORY L.J. 99, 315 (1988) for a discussion of the development of 10b-5 jurisprudence.

19. Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 6 (1985) (emphasis in original), quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976).

20. SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir. 1999).

21. Securities Act of 1933, 15 U.S.C. § 77a (2006).

22. Investment Company Act of 1940, 15 U.S.C. § 80a-1 (2006).

23. Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 (2006).

24. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7241 (2006); 18 U.S.C. § 1350 (2006).

Regulation of securities markets began as a reaction to pervasive and well-documented fraud perpetrated on retail investors by corporate insiders and professional traders, contained in practices colorfully nominated as "stock watering," "bear raids," and "bucket shops."[25] The Supreme Court cited the exchanges "inability and unwillingness to curb abuses" as the impetus for the passage of the 1934 Act.[26]

The designated remedy for all of these fraudulent practices was to mitigate information asymmetries by mandating the disclosure of all material information to retail investors. The securities statutes are designed primarily to make information available to retail investors, including information about the product being sold as well as information about the seller.

Essentially, sellers of securities operate under certain obligations. The most important obligation is to provide to investors, by making public, information known to insiders that would otherwise affect non-insiders purchase and sale decisions. The anti-manipulation rules do not institute a pricing obligation under the securities laws. A seller may charge what the market will bear as long as the market is fully informed and free from fraud or manipulation.

B. FERC Order No. 670

In 2005, Congress augmented the FERC's authority to address potential manipulation of markets under the FERC's jurisdiction. The Energy Policy Act of 2005 amended the Natural Gas Act[27] and the Federal Power Act[28] to prohibit the same type of conduct prohibited in the 1934 Securities Act, namely 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] . . .)."[29] In 2006, the FERC promulgated Order No. 670, identical in many respects to SEC Rule 10b-5, prohibiting the use or employment of "any manipulative or deceptive device or contrivance," and stated its intention to interpret its rule "consistent with analogous SEC precedent that is appropriate under the circumstances."[30]

The FERC determined that it generally would define conduct as manipulative in cases where an entity:

> (1) Uses 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

25. *See, e.g.*, Stock Exchange Practices, Report of the Committee on Banking & Currency, S.Rep. No. 1455, 73d Cong. 2d Sess. (1934).

26. Silver v. New York Stock Exchange, 373 U.S. 341, 351 (1963), citing S.Rep. No. 792, 73d Cong. 2d Sess. 2-5 (1934), and H.R. Rep. No. 1383, 73d Cong. 2d Sess. 15 (1934).

27. 15 U.S.C. § 717c-1 (2006).

28. 16 U.S.C. § 824v (2006).

29. Energy Policy Act of 2005, 15 U.S.C. § 717c (2006) and 16 U.S.C. § 824v (2006) [hereinafter *EPAct 2005*].

30. Prohibition of Energy Market Manipulation, 71 Fed. Reg. 4,244 (Jan. 26, 2006) (to be codified as 18 C.F.R. pt. 1c).

> 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]

Although the FERC's decision to craft a rule modeled on SEC Rule 10b-5 was not mandatory, the enabling legislation expressly directed the FERC to be guided by the term "manipulation" as that term is used in securities law.[32] A number of commenters to the FERC's proposed anti-manipulation rule pointed out several differences in the framework of securities markets and the markets subject to the FERC's jurisdiction.[33] The securities model is one of disclosure, designed to protect unsophisticated investors from insider trading with access to more complete information. Parties subject to the FERC regulation, by contrast, are typically sophisticated entities employing professional traders. Additionally, the securities laws do not attempt to enforce "just and reasonable" prices, a key feature of the FERC regulatory regime.

The FERC acknowledged the difference in market frameworks pointed out by the commenters, but nonetheless chose to follow SEC precedent. The FERC recognized that

> the SEC does not have a duty to assure that the price of a security is just and reasonable, and that our duty is not to protect purchasers through a regime of disclosure. Despite these differences in mission, however, wholesale natural gas and power markets, like securities markets, are susceptible to fraud and market manipulation, regardless of the level of sophistication of the market participants.[34]

In deciding to follow the SEC model, the FERC thought that the existing anti-manipulation case law would provide "a level of substantial certainty"[35] as to how its new regulations would operate, and would also provide "clarity"[36] to affected parties. Although agreeing with commenters that a "wholesale overlay of the securities laws onto energy market is overly simplistic,"[37] the FERC thought it should not ignore the useful guidance contained therein, particularly because Congress deliberately modeled the Energy Policy Act on the securities statutes.

To protect against an "overly simplistic" reliance on securities precedent, the FERC provided certain clarifications to address the "differences between the SEC's regulation of securities markets and our regulation of markets for natural gas and electricity."[38] First, the FERC clarified that Order No. 670 did not create a new affirmative duty of disclosure, relying on the fact that SEC Rule 10b-5 also did not create a duty of disclosure. Rather, the duty to disclose in a securities market transaction is created by a fiduciary relationship between traders or some

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31. *Id.* at 4,253.
32. *EPAct 2005*, *supra* note 29, amending 15 U.S.C. § 717c (2006) and 16 U.S.C. § 824v (2006).
33. Prohibition of Energy Market Manipulation, *supra* note 30, at 4,249-50.
34. *Id.* at 4,250.
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*

other duty imposed elsewhere in the securities laws.[39] Thus, Order No. 670 imposes no duty to disclose absent some tariff requirement or other FERC directive.[40] Second, the FERC clarified that Order No. 670 did not change its own precedent on contract law. Noting that private contracts are fundamental to the functioning of energy markets, the FERC reiterated that it expects parties to resolve contract disputes privately, relying on the courts to apply contract law as appropriate.[41] Third, the FERC clarified its intention with regard to material omissions.[42] Although the Order does not create any affirmative duty to disclose, the FERC noted that where an entity voluntarily provides information, or provides it pursuant to a FERC requirement, the omission of a material fact may then violate Order No. 670. The FERC considers these omissions on a case-by-case basis, pursuing enforcement action only when they occur in, or have an effect in, jurisdictional transactions.

Thus, the FERC's decision to follow SEC precedent in crafting its order seems grounded in three reasons: 1) Congress modeled the FERC's authority directly on the SEC's authority; 2) using long-standing SEC precedent would give those subject to the law some clarity as to how the law would be enforced; and 3) the natural gas and electricity markets subject to FERC jurisdiction may be similarly as susceptible to manipulation as the securities markets. Also recognizing the differences in market frameworks between securities markets and energy markets, the FERC clarified a number of points regarding those differences and noted that it would rely on case-by-case prosecutorial discretion to limit its actions to those instances in which there is an effect beyond the parties to the transaction.

Since Order No. 670 took effect in 2006, the FERC began a number of investigations, noting in its 2009 Annual Enforcement Report that "conduct involving fraud and market manipulation poses a significant threat to the markets overseen by the Commission."[43] Several of those initiatives culminated in 2009, and the FERC "collected over $38 million in civil penalties and nearly $39 million in disgorged profits through settlements" in fiscal year 2009.[44] These recent cases show that the FERC

39. Chiarella v. United States, 445 U.S. 222, 223 (1980) (The [10b] cases also have explained, in accordance with the common law rule, that "[t]he party charged with failing to disclose market information must be under a duty to disclose it.") (*quoting* Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975)).

40. *Prohibitions on Market Manipulation*, *supra* note 6, at 4,251.

41. *Id.*

42. *Id.* at 1c.1(a)(2) and 1c.2(a)(2) state that "to make any untrue statement of 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. . ."

43. Federal Energy Regulatory Commission, *2009 Report on Enforcement,* Docket No. AD07-13-002 (Dec. 17, 2009) at 2.

44. *Id.* at 3. Two settlements occurred in cases relating to the FERC's allegation of manipulation of wholesale natural gas prices over a number of months at the Houston Ship Channel trading point. Amaranth Advisors and affiliates settled before trial for a payment of a $7.5 million penalty. *In re Amaranth Advisors,* 128 F.E.R.C. ¶ 61,154 (July 8, 2009). Energy Transfer Partners also settled in a related case, agreeing to pay a $5 million civil penalty and $25 million into a disgorgement fund. *Energy Transfer Partners, L.P.*, 128 F.E.R.C. ¶ 61,269 (Sept. 21, 2009). In both cases, the FERC charged that the companies held derivative

remains committed to enforcing its market manipulation rule against conduct that it believes may result in artificial prices in markets over which it has jurisdiction.

C. CFTC Framework

A third important anti-manipulation enforcement scheme exists, but unlike the SEC and the FERC, the CFTC prohibits market manipulation through a self-implementing statute that did not require a rulemaking.[45] In particular, CFTC actions regarding manipulation are brought under the statutory provisions of the Commodity Exchange Act. The Supreme Court has observed that the primary purpose of the 1974 amendments to that Act was to protect "against manipulation of markets and to protect any individual who desires to participate in futures market trading."[46] The main market manipulation provision of the statute is 13(a)(2), which 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 or knowingly to deliver or cause to be delivered for transmission through the mails or interstate commerce by telegraph, telephone, wireless, or other means of communication false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce. . .[47]

Fraud, false reporting, and misrepresentation are also covered in several other provisions of the CEA.[48] In addition, the statute expressly prohibits specific actions in connection with futures contracts. Specifically, it is unlawful to perform "wash sales," "accommodation trades," "fictitious sales," or any activity that causes a price to be reported which is not a true and bona fide price.[49]

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positions that gave them an incentive to drive the price of natural gas to artificially low levels. In a third action, a FERC Administrative Law Judge held that an Amaranth trader violated Rule 670 by engaging in conduct that was "fraudulent with the requisite scienter and with reckless disregard to jurisdictional transactions." *FERC v. Brian Hunter*, Docket No. IN07-26-004 (Jan. 22, 2010) slip op. at 78.

45. CFTC regulations are found at 17 C.F.R. pt. 1 (2005). Appendix A and B to pt. 38 both mention the phrase "market manipulation" as do sections 36.3, Exempt Commercial Markets, and section 21.03, Selected Special Calls. There has been some congressional dissatisfaction with the CFTC standard for addressing manipulation in the markets it oversees. Recently, Senator Cantwell and Senator Nelson of Florida introduced S. 1682, the Derivatives Market Manipulation Prevention Act of 2009, Cong. Rec. S9556 (Sept. 17, 2009). The statute is similar to EISA, except that it directs that the CFTC "shall" promulgate anti-manipulation rules within one year of passage (1682 § 2(c)(1)), and establishes a recklessness scienter standard for the prohibition of false information (1682 § 2(c)(2)). At least one CFTC Commissioner has endorsed loosening the Commission's specific intent scienter standard and the requirement that the CFTC prove the existence of an artificial price. *See* Remarks of Commissioner Bart Chilton before the Institutional Investors Carbon Forum, the Metropolitan Club, New York, N.Y., *Moment of Inertia* (Sept. 15, 2009), at 6-7, *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opachilton-26.pdf.

46. Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Curran, 456 U.S. 353, 372 (1982) (*quoting* U.S. Senator Robert Dole).

47. 7 U.S.C § 13(a)(2) (2006); 7 U.S.C. § 9(a)(2) (2006).

48. 7 U.S.C. § 6b (2006). Fraud, false reporting, or deception prohibited; 7 U.S.C. § 6h (2006), False self-representation as registered entity member prohibited; 7 U.S.C. § 6o (2006), Fraud and misrepresentation by commodity trading advisors, commodity pool operators, and associated persons.

49. 7 U.S.C. § 6c (2006), Prohibited transactions.

The CEA also authorizes the CFTC to reduce excessive speculation that can cause "sudden or unreasonable price fluctuations or unwarranted changes in the price" of commodities, because it is "an undue and unnecessary burden on interstate commerce."[50] The CFTC can set limits on the amount of trades that can be made and the amount of positions that can be held.[51]

The rationale for the CFTC authority seems to be to prevent the establishment of an "artificial price." The Seventh Circuit has defined manipulation under the CEA as an "intentional exaction of a price determined by forces other than supply and demand."[52] The court articulated the elements for proving manipulation, which include establishing "(1) that the accused holds a controlling dominant long position in the market; (2) that the accused specifically intends to execute a squeeze; (3) that an artificial price exists at the time of the offense; and (4) that the accused causes the artificial price."[53]

Historically, the CFTC challenged market manipulation only in the futures markets. More recently, however, it has begun to assert jurisdiction in the physical markets. The CFTC statute prohibits price manipulation "of any commodity in interstate commerce, or for future delivery. . ."[54] The CFTC asserts, and at least one court has explicitly agreed, that the CEA gives the agency authority to regulate any commodity.[55]

Traditionally the CFTC has been concerned with four types of market manipulation: corners, squeezes, false reports, and false rumors or information.[56] However, "marking the close," "bidding up," and manipulation by the "short" side are also within the scope of the CEA.

Because there is no statutory definition of market manipulation in the CEA, the contours of manipulation used by the agency were developed by the courts prior to the establishment of the CFTC in 1975.[57] The common thread is the intentional creation of an artificial price.[58] So far, cases

50. 7 U.S.C. § 6a (2006), Excessive speculation.

51. *Id.*

52. Frey v. Commodity Futures Trading Commission, 931 F.2d 1171, 1175 (7th Cir. 1991).

53. *Id.*, *citing* G. H. Miller & Co. v. United States, 260 F.2d 286 (7th Cir. 1958), *cert. denied,* 359 U.S. 907 (1959).

54. 7 U.S.C. § 13(a)(2) (2006).

55. United States v. Valencia, 2003 WL 23174749, at *2 (S.D. Tex. 2003), *rev'd on other grounds*, 394 F.3d 352 (5th Cir. 2004).

56. A corner may occur when a trader obtains a particularly large long position. In this instance, "market power" price manipulation may be possible if the trader owns a sufficient amount of the deliverable supply such that the trader can force sellers into shorts in order to cover their positions, otherwise known as a squeeze.

57. The CFTC replaced the Commodity Exchange Authority, a small agency located in the Department of Agriculture. *See* William. T. Bagley, *The Birth of the CFTC*, SWISS DERIVATIVES REVIEW, Nov. 2004, at 1.

58. *See e.g.* Volkart Bros., Inc. v. Freeman, 311 F.2d 52, 58 (5th Cir. 1962) (Manipulation requires "a purpose to create prices not responsive to the forces of supply and demand; the conduct must be "calculated to produce a price distortion."); General Foods Corp. v. Brannan, 170 F.2d. 220, 231 (7th Cir. 1948) (Manipulation is "the creation of an artificial price by planned action, whether by one man or a group of men.") (quoting approvingly definition contained in government brief); Cargill v. Hardin, 452 F.2d. 1154, 1163 (8th Cir. 1971) ("[T]he test of manipulation [is] ... to discover whether conduct has been intentionally engaged in which has resulted in a price which does not reflect basic forces of supply and demand."); Hohenberg Brothers,

reject the proposition that it is necessary to plead a fraudulent act for a manipulation claim under the CEA because the CEA has separate sections for fraud and manipulation.

Neither making a profit nor market control is required to find market manipulation.[59] False rumors, which require no market control, are one of the most common types of manipulation.[60] Additionally, the CFTC has brought enforcement actions against single traders for their unilateral acts of market manipulation.[61]

Recent court and CFTC decisions discuss the four elements that the CFTC must prove to prevail on a charge of unlawful manipulation: ability, intent, artificial price, and causality.[62] The defendant must have had the ability to influence prices, but actual market control is not required.[63] The defendant must have acted intentionally with the purpose of influencing price.[64] An artificial price must actually result, but it does not matter if it is higher or lower than market forces would otherwise dictate. The end price itself is not as important as the factors that caused it.[65] Finally, the actions of the accused must cause the price changes; however, they need not be the sole cause, just the proximate one.[66]

Proof of intent is usually circumstantial; therefore, courts will infer intent from the accused party's actions or from the totality of the circumstances.[67] However, manipulative intent cannot be inferred solely from seeking a higher price for one's commodities.[68]

CFTC No. 75-4 (Comm. Fut. L. Rep. Feb. 18, 1977) WL 13562, at *13568 ("the performance of an act or conduct which was intended to effect an artificial price").

59. Cargill, 452 F.2d. at 1163.

60. *See, e.g.*, *In re* Soybean Futures Litigation. 892 F. Supp. 1025, 1045-47 (N.D. Ill. 1995) (denying summary judgment where plaintiffs claim manipulation through false rumors of cash market for soybeans).

61. Press Release, CFTC, Former BP Trader Paul Kelly Agrees to Pay $400,000 Civil Penalty to Settle U.S. Commodity Futures Trading Commission Charges of Attempted Manipulation of the NYMEX Unleaded Gasoline Futures Contract (Oct. 25, 2007); Press Release, CFTC, U.S. Commodity Futures Trading Commission Settles Natural Gas False Reporting and Attempted Manipulation Lawsuit with Energy Trader-Defendant Paul Atha, a Former Trader at Mirant Americas Energy Marketing, L.P., Ordered to Pay a $200,000 Penalty (Nov. 8, 2007).

62. *See, e.g.*, CFTC v. Enron Corp., 2004 WL 594752, at *4 (S.D. Tex. March 10, 2004).

63. *Id*. at *4, *5.

64. Indiana Farm Bureau Cooperative Ass'n, 1982 WL 30249 at *17 (C.F.T.C. Dec. 17, 1982).

65. *Id*.

66. Enron, *supra* note 62, at *7. Significantly, a recent decision, although not altering the elements to be proved nonetheless added definition to the element of creating an artificial price. U.S. v. Radley, 2009 WL 3013457, at *8, 10 (S.D. Tex. 2009). The district court granted motions to dismiss on all counts charging former employees of BP America Production Company (BP) with, inter alia, unlawful price manipulation and attempted price manipulation of Texas Eastern Corporation propane. In so doing, the court found the Commodity Exchange Act unconstitutionally vague respecting the count specific to price manipulation "because the term 'manipulation' as used in the CEA is vague as it is applied to the allegations in this case." Furthermore, the court held that the government did not prove that the alleged artificial price was one set by behavior outside the legitimate forces of supply and demand. In so holding, the court observed that "[m]aking a profit is a legitimate commercial purpose . . . [and that the government] never alleges that the defendants lied about their activity. Mere concealment is not sufficient to show that their actions were not legitimate forces of supply and demand."

67. *See, e.g.*, Indiana Farm Bureau, *supra* note 64; *In re* Hohenberg Bros., *supra* note 58.

68. *Id.*; Volkart Bros., Inc., *supra* note. 58, at 58-59; Brannan, *supra* note 58, at 231.

CFTC statutes also recognize a cause of action in attempted manipulation, which has been defined as "simply a manipulation that has not succeeded; that is, the conduct engaged in has failed to create an artificial price."[69] The element of intent is the same for both actual and attempted manipulation,[70] but the attempt action also requires proof of an overt act in furtherance of that intent.[71] There is no requirement to show the action would have had the capability to influence market prices.[72]

The FTC staff determined that each of these enforcement regimes was instructive to its work in promulgating a rule to implement section 811. Although not specifically directed to use SEC precedent as the FERC was in the Energy Policy Act, the Commission determined that the identical language of section 811 to the enabling language of the SEA warranted an anti-fraud rule modeled closely on Rule 10b-5. Additionally, FERC and CFTC experience with prohibiting market manipulation in energy markets provided important guidance. Thus, the Commission was not forced to start its effort from a blank slate, but was able to rely on substantial agency learning and court guidance to draft a rule that would target manipulation while having as small an adverse impact as possible on efficient business conduct.

III. THE RULEMAKING PROCESS AND THE FINAL RULE

The Commission's rulemaking proceeding began with an Advanced Notice of Proposed Rulemaking (ANPRM).[73] In response to the solicitation of comments about the scope and appropriateness of a rule, the Commission received 155 comments.[74] After reviewing the comments, the Commission published a Notice of Proposed Rulemaking (NPRM), proposing a rule modeled on SEC Rule 10b-5, and inviting further written comments.[75] In response to the NPRM, the Commission received an additional thirty-six comments, most from persons or entities that had already commented at the ANPRM stage.[76]

After reviewing the second round of comments, the Commission staff held a public workshop to discuss the issues raised by the proposed rule, including the use of SEC Rule 10b-5 as a model for the proposed FTC rule, the appropriate scope and reach of a rule, the proper scienter

69. Enron, *supra* note 62, at *7.

70. CFTC v. Amaranth Advisors, 554 F. Supp. 2d 523 (S.D. N.Y May 2008), *available at* http://www.cftc.gov/stellent/groups/public/@lrenforcementactions/documents/legalpleading/enfamaranthopinion052108.pdf.

71. CFTC v. Johnson, 408 F. Supp. 2d 259, 267 (S.D.Tex. 2005).

72. *See e.g.*, Amaranth Advisors, *supra* note 70.

73. ANPR, *supra* note 9, at 25,614. Public rulemaking materials are available at: http://www.ftc.gov/ftc/oilgas/rules.htm.

74. Comments to the Federal Trade Commission's ANPR *available at* http://www.ftc.gov/os/comments/marketmanipulation/index.shtm (last visited February 7, 2010) [hereinafter *ANPR Comments*].

75. Notice of Proposed Rule Making, 73 Fed. Reg. 48,317-01, 48,317 (Aug. 19, 2008) (to be codified at 16 C.F.R. pt. 317) [hereinafter *NPRM*].

76. Comments to the Federal Trade Commission's NPRM, *available at* http://www.ftc.gov/os/comments/marketmanipulation2/index.shtm.

standard for the rule or particular parts of the rule, the conduct to be prohibited, and whether a showing of price or other market effects should be part of the proposed rule.[77]

Commission staff used the learning from the comments and the workshop to draft and publish a Revised Notice of Proposed Rulemaking (RNPRM).[78] The RNPRM set forth a fraud-based rule, but with substantial modifications to the proposed rule designed to account for differences between the securities markets and wholesale petroleum markets. The Commission solicited further comments on the modified rule, and received seventeen additional comments in response.[79] The Commission then issued its final rule with only minor modifications from the rule published in the RNPRM.[80]

IV. SCOPE OF THE RULE

The jurisdiction of the Commission under EISA is the same as that traditionally enjoyed under the FTC Act.[81] Section 813(a) of EISA provides that it shall be enforced "in the same manner, by the same means, and with the same jurisdiction as though all applicable terms of the [FTC] Act . . . were incorporated into and made a part of [Subtitle A]."[82] Thus, any person subject to Commission jurisdiction under the FTC Act is covered by the rule.[83] Similarly, any limitations to FTC jurisdiction are incorporated into EISA.

The Commission received two comments advocating limitations to its jurisdiction for particular types of transactions.[84] The Association of Oil Pipelines asked the Commission to exempt interstate common carrier oil pipelines from the reach of the rule because they are regulated by the

77. Federal Trade Commission, Market Manipulation Rulemaking Workshop (Nov. 6, 2008).

78. Revised Notice of Proposed Rule Making, 74 Fed. Reg. 18,304-01, 18,304 (Apr. 22, 2009) (to be codified at 16 C.F.R. pt. 317) [hereinafter, *RNPRM*].

79. Comments to the Federal Trade Commission's RNPRM, *available at* http://www.ftc.gov/os/comments/marketmanipulation3/index.shtm.

80. Prohibitions on Market Manipulation, *supra* note 6, at 40,686. One of the four Commissioners sitting at the time the final rule was promulgated dissented. Commissioner Kovacic believed that the rule, as drafted, would not only proscribe harmful conduct, but would also inadvertently reach legitimate business conduct, thus risking a chilling of pro-competitive commerce. He argued that a better rule, and one that he could support, would be a single prohibition on intentional fraudulent or deceptive conduct that actually or likely distorts market conditions (*i.e.*, the better rule would have a single scienter standard, would require proof of a market impact for all violations, and would not establish a separate provision focused on omissions). *See also* Dissenting Statement of Commissioner William E. Kovacic, *Crude Oil Price Manipulation Rule Making*, Project No. P082900, *available at* http://www.ftc.gov/os/2009/08/P082900mmr_kovacic.pdf.

81. 15 U.S.C. § 41 (2006).

82. 42 U.S.C. § 17303 (2006).

83. Those persons subject to FTC jurisdiction are also subject to section 812.

84. The Commission also received a comment at the ANPRM stage suggesting that the rule should not cover banks or non-profit institutions. *See* ANPR Comments, *supra* note 74, at 3-4. The Commission noted that, although it does not have jurisdiction over certain defined banks, savings and loan associations, and federal credit unions, it nonetheless has jurisdiction over "entities affiliated with or contracting with banks that are themselves not banks." The Commission stated that whether the rule applied to such entity would be assessed on a case-by-case basis. *NPRM*, *supra* note 75, at 48,324.

FERC under the Interstate Commerce Act (ICA).[85] The Commission declined to grant the pipelines a safe harbor, reasoning that not all pipeline activity falls outside of FTC jurisdiction.[86] Although common carrier activity is not covered by the FTC Act,[87] pipelines or their affiliates may engage in conduct in connection with wholesale petroleum markets, including buying or selling petroleum products. The Commission thus determined that it would decide on a case-by-case basis whether any particular person or conduct pertaining to pipelines comes under the "in connection with" language in the final rule.[88]

A second set of comments urged that the Commission not extend its jurisdiction to the futures markets, observing that section 2(a)(1)(A) of the Commodities Exchange Act appears to grant exclusive jurisdiction over futures industry products to the CFTC.[89] These commenters reasoned that an FTC rule that would cover futures products would risk inconsistent regulatory approaches.[90] Additionally, market participants might become subject to duplicative or conflicting enforcement efforts that would impose additional costs.[91]

The Commission declined to adopt a safe harbor for futures and derivatives trading. The Commission rejected the CFTC's claim of exclusive jurisdiction over manipulation relating to commodities futures markets.[92] Instead the Commission noted that the favored approach of the courts has been to recognize concurrent jurisdiction for all statutory and

85. Ass'n of Oil Pipe Lines (AOP), *Comments of the Ass'n of Oil Pipe Lines on Revised Notice of Proposed Rulemaking*, Project No. P082900 (2009) (asking the Commission to refrain from applying any rule to common carrier oil pipelines, including crude oil and petroleum products pipelines).

86. The Commission can prosecute anticompetitive mergers of pipelines under the authority of The Clayton Act, 15 U.S.C. §§ 18, 21 (2006).

87. FTC jurisdiction under the FTC Act does not extend to common carriers that are subject to the ICA, including interstate rail, trucking and busing; domestic offshore water carriage; and pipelines carrying commodities other than water, gas, or oil. 49 U.S.C. §§ 10101-16106 (2006).

88. *Prohibitions on Market Manipulations*, *supra* note 6, at 40,686.

89. 7 U.S.C.§ 2(a)(1)(A) (2006); Section 2 of the CEA states:

> [t]he [CFTC] shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery . . . traded or executed on a contract market designated . . . pursuant to [S]ection 7 or 7a of this title of the CEA.

90. *See, e.g.*, Letter from Terry S. Arbit, General Counsel, Commodity Future Trading Commission, Re: Market Manipulation Rulemaking, PO812900 (Sept. 19, 2008) at 1. "We again urge the FTC to incorporate an exception from its rule for commodity futures and options trading activity on regulated futures exchanges, which is subject to the CFTC's exclusive jurisdiction"; *ANPR Comments*, *supra* note 74, at 5 (urging the Commission to grant a safe harbor futures and options trading). *But see* California Attorney General (CAAG), NPRM Comments (Oct. 17, 2008) at 3-4 (requesting that no safe harbor be provided in order to avoid "shackling the FTC with the restrictions placed upon CFTC authority").

91. *See, e.g.*, Letter from R. Trabue Bland, Director of Regulatory Affairs, Intercontintental Exchange, Inc., ANPRM Comments (June 23, 2008) at 2 ("Duplicative enforcement and regulation is unduly burdensome and could possibly deprive market participants of due process"); Letter from Michael A. Caldarera, Vice-President, Regulatory and Technical Services, National Propane Gas Ass'n (NPGA), ANPRM Comments (June 23, 2008) at 2 ("A flawed regulatory scheme may result in . . . penalties being cumulative and ultimately excessive").

92. NPRM, 73 Fed. Reg. 48,317-01 (August 19, 2008) (to be codified at 16 C.F.R. pt. 317) ("CFTC authority over manipulation relating to commodities futures markets is not exclusive and, moreover, is separate from CFTC's exclusive authority under CEA Section 2(a)(1)(A)").

regulatory schemes that address the alleged illegal conduct.[93] Additionally, the EISA statute gives no indication that Congress intended to exempt the futures industry from any Section 811 rule. A letter to the Commission from U.S. Senator Maria Cantwell, an advocate of Sections 811 and 812, notes that "Congress clearly intended for the Commission's new anti-manipulation authority to cover commodity futures and options trading activity that impacts wholesale petroleum markets."[94]

The Commission noted that it does not intend to impose contradictory or duplicative requirements on futures market participants.[95] Although acknowledging the potential for imposing additional compliance costs, the Commission pledged to coordinate its enforcement efforts with other agencies that might have complementary or overlapping jurisdiction.[96] A number of commenters expressed concern over this issue and urged the various agencies to coordinate their activities with care to avoid undue costs on the industry.[97]

V. PROHIBITED PRACTICES

Section 811 of EISA authorized the Commission to craft an anti-fraud rule guided by the principles of SEC Rule 10b-5 and the learning found in court decisions interpreting that rule. The main focus of those sources is the protection of market integrity,[98] and the comments reflected overwhelming support for accomplishing that goal through an anti-fraud rule.[99] The "necessary or appropriate" language found in section 811 gave

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93. FTC v. Ken Roberts Co., 276 F.3d 583, 593 (D.C. Cir. 2001) (holding that the FTC's authority under the FTC Act to investigate deceptive marketing of commodities trading courses did not conflict with the CFTC's exclusive authority under CEA 2(a)(1)(A)); United States v. Reliant Energy Serv., 420 F. Supp. 2d 1043, 1062 (N.D. Cal. 2006) (holding that FERC's exclusive jurisdiction to regulate wholesale electricity markets did not bar CFTC enforcement action against commodities price manipulation); SEC v. Hopper, 2006 WL 778640 (S.D. Tex. Mar. 24, 2006) (allowing the SEC to challenge fraudulent and deceptive energy trading transactions under Rule 10b-5, despite assertions that the CFTC and FERC had exclusive jurisdiction over commodities transactions and interstate wholesale electricity rates).

94. Letter of Senator Maria Cantwell to Chairman Jon Leibowitz and Commissioners Pamela Harbor, William Kovacic, and J. Thomas Rosch (May 20, 2009) at 2, *available at* http://www.ftc.gov/os/comments/marketmanipulation3/541354-00018.pdf.

95. *RNPRM*, *supra* note 78, at 18,304.

96. *Prohibitions on Market Manipulation*, *supra* note 6, at 40,686.

97. *See, e.g.*, Intercontinental Exchange, Inc., *supra* note 91, at 2. ("The Commission should coordinate with FERC and the CFTC to define their respective roles in the energy markets"); Petroleum Marketers Ass'n of Am. (PMAA), ANPRM Comments (June 23, 2008) at 6 (recommending the formation of a standing inter-agency task force on market manipulation charged with coordination and information sharing); Int'l Swaps and Derivatives Ass'n (ISDA), ANPRM Comments (June 23, 2008) at 4 (encouraging the Commission to coordinate with the CFTC).

98. *See, e.g.*, U.S. v. Russo, 74 F.3d 1383, 1391 (2d Cir. 1996) ("[F]rauds which mislead the general public as to the market value of securities" and "affect the integrity of the securities market . . . fall well within [Rule 10b-5].") (internal quotations omitted); *see also* Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (stating that "preserving the integrity of the securities markets" is one of the purposes of Section 10(b).

99. *See, e.g.*, NPGA, *supra* note 91, at 2 (stating that a rule should target fraudulent and deceptive practices); PMAA, *supra* note 97, at 5 (stating that fraud is an appropriate basis for a Section 811 rule); Air Transportation Ass'n of Am., Inc., NPRM Comments (June 23, 2008) at 11 (supporting an anti-fraud rule).

the Commission flexibility to use its expertise in wholesale petroleum markets to tailor a rule to the specific characteristics of those markets.[100]

There are a number of differences in securities and wholesale petroleum markets, and the Commission recognized that those differences made it appropriate to modify the Rule 10b-5 language in the final rule.[101] The first such difference is the information disparity that exists between retail securities investors and securities brokers.[102] This disparity forms the basic pillar of all securities regulation. By contrast, participants in wholesale petroleum markets are mostly sophisticated commercial traders who are able to engage in a substantial amount of self protection. Second, the markets differ in the amount of additional regulatory structure present in each. State and federal governments have a highly visible regulatory presence in securities markets, in particular enforcing substantial and comprehensive disclosure requirements. The SEC also enforces a system of licensing and training requirements and can ban participants who do not comply with the regulations. This kind of comprehensive regulatory overlay is not present in wholesale petroleum markets.

The Commission's final rule thus has several differences with Rule 10b-5 that are designed to prohibit fraudulent conduct while permitting legitimate commercial conduct to proceed unfettered. First, the Commission determined that a two-part rule, focused on fraudulent conduct and fraudulent omissions, "more clearly and precisely denote[s] the unlawful conduct [that the rule] prohibits."[103] Second, in order to reduce the risk of chilling legitimate commercial conduct, the rule adopts a different scienter standard for each section of prohibited conduct, requiring a "knowingly" standard for overt instances of fraud or deception, but an "intentional" standard for a material omission. Finally, in order to address the concern that the omissions section might make firms less willing voluntarily to provide disclosures of information valuable to buyers and sellers, the Commission added a requirement that

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100. The FTC has substantial experience in studying and reporting on petroleum industry activities. *See, e.g.*, Letter of Richard C. Donohue, Acting Secretary, FTC, Pacific Northwest Gasoline and Diesel Fuel Prices Investigation (closing letter), File No. 071 0163, *available at* http://www.ftc.gov/os/closings/080822pacificnwvaleroclosingletter.pdf.; FTC, REPORT ON SPRING/SUMMER 2006 NATIONWIDE GASOLINE PRICE INCREASES (2007), *available at* http://www.ftc.gov/reports/gasprices06/P040101Gas06increase.pdf; FTC, INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GASOLINE PRICE INCREASES (2006), *available at* http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf; FTC, GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (2005), *available at* http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf; FTC, Statement Concerning Shell Oil Company, FTC File No. 041-0087 (May 25, 2005), *available at* http://www.ftc.gov/os/caselist/0410087/050525stmnt0410087.pdf; FTC, Bureau of Economics, THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT (2004), *available at* http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf; FTC, FINAL REPORT: MIDWEST GASOLINE PRICE INVESTIGATION (2001) *available at* http://www.ftc.gov/os/2001/03/mwgasrpt.htm. Beginning in 2005 the Commission has also produced annual reports on ethanol market concentration; FTC, 2007 REPORT ON ETHANOL MARKET CONCENTRATION (2007), *available at* http://www.ftc.gov/reports/ethanol/2007ethanol.pdf.

101. *Prohibitions on Market Manipulation*, *supra* note 6, at 40,690.

102. Donald C. Langevoort and G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VANDERBILT L. REV. 1639, 1640 (2004) ("[T]he federal securities laws are, at heart, about disclosure. . . .").

103. *RNPRM*, *supra* note 78, at 18,316.

any prohibited omissions distort, or be likely to distort, market conditions for any covered product.[104]

A. Section 317.3(a): General Anti-Fraud Provision

According to the SBP, subpart (a) of the Rule is designed to prohibit overt fraud and deception. It prohibits a person from knowingly engaging in conduct that operates or would operate as a fraud or deceit on any person. The subpart reaches outright lying, as well as affirmative statements that deceive. The SBP notes that there is no economic justification for such conduct – it has no legitimate business purpose and will impair the efficiency of wholesale markets.[105] As a consequence, the elements of proof for subpart (a) differ from those of subpart (b) in two important respects. First, subpart (a)'s scienter standard is a lower "knowingly" standard, requiring that the actor knew or must have known that the conduct was fraudulent or deceptive regardless of whether the actor intended that result. Second, unlike subpart (b), which addresses material omissions, subpart (a) does not require that the Commission prove a market impact.

These differences reflect the fact that a well-functioning exchange economy is based on voluntary transactions that are mutually beneficial to both sides of any transaction. Involuntary transactions – *e.g.*, such as robbery at gunpoint – are inefficient because they would not have taken place but for the use of force or other antisocial act. Overt fraud or deception similarly generates inefficient results. When there is material reliance on the fraudulent or deceptive statements of another, transactions either may take place that otherwise would not have or do not take place but for the fraud or deception. Either way, wealth generation and economic efficiency are impeded.

The record in the rulemaking proceeding strongly supported the enactment of a general anti-fraud provision.[106] The Canadian Association of Petroleum Producers (CAPP) noted that "[m]anipulative conduct that makes use of false information in market transactions does not constitute routine or acceptable commercial behavior."[107] No commenter raised substantive concerns about capturing overtly fraudulent behavior in the final rule.

Significantly, subpart (a) does not overlap with subpart (b) by reaching fraudulent or deceptive omissions. When it published the RNPRM, the Commission had stated that omissions would be covered by part (a). In the SBP for the final rule, however, it concluded that the better course is to subject unlawful omissions only to enforcement under

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104. As an aid to complying with the Final Rule, the Commission staff published a set of guidelines. FTC, GUIDE TO COMPLYING WITH PETROLEUM MARKET MANIPULATION REGULATIONS (Nov. 2009), *available at* http://www.ftc.gov/os/2009/091113mmrguide.pdf.

105. *Prohibitions on Market Manipulation*, *supra* note 6, at 40,695.

106. *RNPRM*, *supra* note 78, at 18,308; *NPRM*, *supra* note 75, at 48,319; *Prohibitions on Market Manipulation*, *supra* note 6, at 40,695.

107. Letter of Mark Pinney, Canadian Ass'n of Petroleum Producers (CAPP), RNPRM Comments (May 20, 2009) at 2.

final Rule Section 317.3(b).[108] Thus, the Commission reconsidered the inclusion of omissions in subpart (a) because of the potential for confusion if omissions were covered by both subparts. In so doing, the Commission determined that there could be unacceptable potential that voluntary disclosures of beneficial market information would be chilled if omissions were covered in part (a).[109]

The SBP lists a number of examples of the type of conduct that would violate section 317.3(a), including "false public announcements of planned pricing or output decisions; false statistical or data reporting; false statements made in the context of bilateral or multilateral communications that result in the dissemination of the false information to the broader market; and fraudulent or deceptive conduct such as wash sales."[110]

None of these conduct patterns is defensible. All are predicated on the actor attempting to gain a negotiating or trading advantage by feeding false information to the counterparty. There is no efficiency basis for fraudulent conduct that injects false information into wholesale petroleum markets. Market participants rely on market information to determine the buy and sell offers they make. When that information is tainted, the market clearing equilibration process is delayed or undermined, and the number and size of transactions are distorted.

Significantly, the statute does not impose any additional affirmative conduct requirements on market participants, and the final rule is consistent with that mandate. Specifically, the Commission did not impose any:

> 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 final Rule would not require covered entities to disclose price, volume, and other data to individual market participants, or to the market at large, beyond any obligation that may already exist.[111]

These limitations are consistent with the Commission's stated desire that the rule not cover inadvertent conduct or legitimate business transactions. Ideally, they ensure that efficient conduct will not be targeted for enforcement.

1. Appropriate Scienter

Any new market manipulation rule – even one grounded in fraud and deception – possesses non-trivial risks of unintended consequences taking the form of either (1) chilling beneficial, efficient conduct or (2) overreaching enforcement that erroneously holds efficient conduct to be unlawful. Notwithstanding there is no legal or economic justification for fraudulent or deceptive acts, those elements of liability alone are unlikely to fully reduce these unintended consequences to acceptable levels absent

108. *Prohibitions on Market Manipulation*, *supra* note 6, at 40,696.

109. *Id*.

110. *Id.* at 40,695.

111. *Id.* at 40,693.

some cabining. This conclusion follows because, unlike instances of fraudulent or deceptive acts against ordinary consumers, which often are characterized by asymmetric information that the individual consumer cannot economically overcome, wholesale sales and purchases in oil and gasoline markets are characterized by sophisticated trading partners generally fully capable of closing information gaps. Thus, fraud and deception on the market that are not capable of being remedied by private litigation or for which there are insufficient incentives for private plaintiffs to act, although possible, is not likely to be a substantial or widespread problem. As a result, any enforcement of the rule necessarily risks erroneously capturing acts that are not actually fraudulent or deceptive.

The Commission has long recognized the enforcement policy trade-offs inherent in different state of mind standards. These trade-offs emerge in both consumer protection and federal competition policy. In instances where the marketplace cost of regulatory error is relatively slight and the sanction on private defendants is also relatively modest, a showing of intent may not be required at all, or at most, a low intent standard may be sufficient to support cost-effective policy decisions. By contrast, when either regulatory error is costly or sanctions are particularly severe, a higher state of mind standard is called for.[112]

In addition to problems of regulatory error, numerous commenters pointed out that a rule that does not establish clear elements of liability could chill not only benign but also efficient conduct by market participants.[113] A rule that does not clearly delineate the boundaries of illegal conduct will "inevitably encourage participants to make safe decisions that are easy to defend on the basis of past practice and established trading patterns."[114] It is, of course, impossible to draft a rule that proscribes each possible individual manipulative and harmful act. A final rule must necessarily have some degree of generality. Nonetheless, a clear legal standard regarding intent serves to provide market

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112. For example, on the competition side, enforcement respecting mergers, non-criminal but anticompetitive agreements among competitors, vertical restraints, and actual monopolization either does not have an intent element at all, or, in the case of actual monopolization, has only a general intent element. Conventional wisdom holds that each of these instances is characterized either by relatively low regulatory risk or is capable of a remedy with a relatively low error cost such as a prospective order or injunction. By contrast, prosecution of criminal price fixing and attempted monopolization require showings of higher standards of intent – the former because of the severe potential penalty on the defendant and the latter because of the higher risk of chilling pro-competitive conduct (*see, e.g.*, Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 226 (1993) ("because cutting prices in order to increase business is often the very essence of competition, mistaken inferences are especially costly because they chill the very conduct the antitrust laws are designed to protect.") (internal quotations omitted).

113. American Petroleum Institute (API), ANPRM Comments (June 23, 2008) at 5, 19-20, *available at* http://www.ftc.gov/os/comments/marketmanipulation/535819-00159.pdf; Petroleum Marketers Assoc. of America (PMAA), ANPRM Comments (June 23, 2008) at 5-6, *available at* http://www.ftc.gov/os/comments/marketmanipulation/535819-00131.pdf; CAPP, ANPRM Comments (June 20, 2008) at 1, *available at* http://www.ftc.gov/os/comments/marketmanipulation/535819-00133.pdf; Society of Independent Gasoline Marketers of America, ANPRM Comments (June 23, 2008) at 5, 8-10, *available at* http://www.ftc.gov/os/comments/marketmanipulation/535819-00162.pdf.

114. Timothy J. Muris & J. Howard Beales, III, ANPRM Comments (July 7, 2008) at 9, *available at* http://www.ftc.gov/os/comments/marketmanipulation/535819-00170.pdf.

participants and their legal counsel with understandable and practical boundaries in which to make business decisions that are unlikely to expose them to regulatory risk. Furthermore, a clear standard helps to reduce prospective uncertainty about the way courts will interpret the rule.

A standard that would capture potential fraudulent conduct without chilling efficient and beneficial business activities would be one based on knowing conduct. Such a standard not only accommodates the inevitable honest mistake but, in addition, is not potentially tied to what other marketplace participants might infer from others statements or representations that may or may not be inaccurate when made because of a whole host of reasons. Some lesser state of mind standard such as negligence – inherently subject to interpretation and inference – could fail to provide the necessary clarity to permit flexible business decisions that are critical to the continued efficient functioning of wholesale oil and gasoline markets.[115]

Recognizing the dangers of an unfettered final rule, the Commission determined that "knowingly" should be the standard of care for part (a) of the final rule.[116] The Commission adopted, in part, the definition of knowingly identified as "extreme recklessness" in the Seventh Circuit.[117] The knowing requirement is not satisfied by a trader putting false information into the market if he does not know it is false. Evidence must be shown the trader either knew or must have known that the information was false; inadvertent conduct or mistakes are insufficient.[118] Although a high burden to prove, the "knowingly" standard is a lesser standard than an intent standard. An intent scienter requirement would require proof that the actor intended to defraud or deceive. A stronger standard for overtly fraudulent conduct would risk allowing harmful conduct to escape condemnation only because a trader, although aware of the risk of fraud or deception, did not intend that result.

Nonetheless, some commenters contended that the lower scienter standard and the absence of a market impact proviso would create a risk that challenges to normal business behavior could be swept erroneously

115. This is not to say, of course, that negligent conduct could not lead to harmful market effects. No rule can be perfectly crafted to capture only harmful acts while permitting all benign or beneficial acts. The relevant issue that the Commission faced was one of minimizing the sum of error costs due to failing to enjoin certain harmful acts and error costs due to chilling efficient activity.

116. All comments that addressed the issue of state of mind agreed that it should be a required element of the final rule. *See, e.g.*, PMAA *supra* note 113, at 4; CAPP, *supra* note 113, at 3. Absent some state of mind element of liability, commenters thoughts that market participants would fear risking sanctions on the basis of an enforcer's after-the-fact second-guessing about why price movements may have occurred. *See also* Muris & Beales, *supra* note 114, at 9.

117. Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir.). The Seventh Circuit requires proof that the defendant knew or must have known that his conduct created a danger of misleading buyers or sellers.. Although the Seventh Circuit indicated in *Sundstrand*, a securities case, that extreme recklessness can be shown by "an extreme departure from the standards of ordinary care." The Commission has determined that this means of proving scienter is inapplicable to wholesale petroleum markets, as such standards of ordinary care are less well defined than in securities markets. *See Prohibitions on Market Manipulations*, *supra* note 6, at 40,692.

118. *Prohibitions on Market Manipulations*, *supra* note 6, at 40,696.

within the reach of subpart (a).[119] Because subpart (a) reaches solely overt fraud and deception, however, it captures, by its own terms, only conduct that is injurious to the price discovery process. The requirements that the Commission prove a fraudulent or deceptive act and independently prove knowledge that the act was fraudulent or deceptive in order to prove a violation should be sufficient safeguards against regulatory overreach. Neither the higher state of mind requirement of subpart (b) nor a demonstration of market impact is therefore justified. If anything, those additional burdens would merely allow injurious conduct to escape successful challenge. Thus, the final rule requires that the Commission show, at a minimum, some "evidence that the defendant's conduct 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."[120]

2. Market Impact Unnecessary

In contrast to section 317.3(b), section 317.3(a) of the final rule does not require that the Commission show a market impact in order to make out a rule violation. According to the SBP, the Commission chose "not to require a showing that prohibited conduct adversely affect market conditions . . . [because] there is no economic justification for overt fraud or deception, a view about which there is no dispute in the rulemaking record."[121] The Commission concluded that "affirmative misstatements are not easily confused with benign conduct."[122] Implicit in this conclusion is the Commission's finding that potential costs from either regulatory overreach or business uncertainty about the application section 317.3(a) are not significant. As discussed below, the Commission reached the opposite conclusion respecting section 317.3(b).

3. Materiality Standard

Not every false statement rises to the level of conduct that would be prohibited by the final rule. A fact would be material, and thus subject to enforcement proceedings, only if there was a substantial likelihood that it would be important to a reasonable person in making a transaction decision because it significantly changed the mix of total information available in the market.[123] This is a factual inquiry to determine if the information at issue is sufficiently important to affect transaction decisions of a reasonable market participant, and thus likely to be significant to participants in the broader market.[124]

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119. *See, e.g.,* API, RNPRM Comments (May 20, 2009) at 32 (stating that a final rule should have a higher scienter standard in order to "reduce the element of subjectivity and uncertainty" that the knowingly standard would introduce).

120. *Prohibitions on Market Manipulations*, *supra* note 6, at 40,696-7.

121. *Id.* at 40,696.

122. *Id.*

123. *RNPRM*, *supra* note 78, at 18,320; *see also* Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988) ("[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." (*quoting* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976))).

124. *Prohibitions on Market Manipulations*, *supra* note 6, at 40,697.

B. Section 317.3(b): Omissions

Although subpart (a) of the final rule covers overt fraud and deception, the Commission was concerned that there were other ways by which market participants could inject distorted information into wholesale petroleum markets. In particular, affirmative statements that are literally true at the time they are made might, by means of intentional omissions, be misleading.[125] Such intentional fraud on the market would have the same chilling effect on efficient trades as outright lying or other overt deception. Thus, the Commission added subpart (b) to the rule to cover material omissions.

A violation of subpart (b) requires first that an affirmative statement be made.[126] The Commission "generally does not intend that Section 317.3(b) reach silence where no statement has been made."[127] However, subpart (b) does not impose an affirmative duty to disclose any information where such duty does not already exist. Nor does subpart (b) create a duty to correct or update information already disclosed.[128]

Despite the fact that subpart (b) contains no additional duty to disclose information, a number of the commenters expressed concern that a rule that reached omissions would be difficult to interpret and obey without chilling the voluntary disclosure of beneficial commercial information. For example, ISDA argued that "[s]uch a requirement would create a level of regulatory risk that would deter market participants from communicating in any substantive way with market participants".[129] The alleged fear is that, faced with a rule that prohibited material omissions, market participants would remain silent and deprive the market of important information.

The Commission determined that a separate omissions prohibition in the rule was warranted because such conduct might "serve as a vehicle to manipulate wholesale petroleum markets even in the absence of affirmative disclosure requirements."[130] However, in response to commenters concerns about the potential chilling effect of an omissions provision, the Commission added two additional features to subpart (b) not found in the subpart (a) in order to protect against overreaching enforcement and to provide greater certainty to the business community as to the scope of the subpart. First, subpart (b) requires a stricter scienter standard, requiring that the omission be intentional and not merely that the

125. McMahan & Co. v. Wherehouse Entm't, Inc., 900 F.2d 576, 579 (2d Cir. 1990) ("Some statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors").

126. *See Prohibitions on Market Manipulations*, *supra* note 6, at 40,700 ("The standard for materiality for Section 317.3(b) is the same as that for Section 317.3(a)").

127. *Id.* at 40,697.

128. *Id.* at 40,698.

129. ISDA, RNPRM Comments (May 20, 2009) at 12-13, *available at* http://www.ftc.gov/os/comments/marketmanipulation3/541354-00014.pdf. *See also* Argus, RNPRM Comments (May 20, 2009) at 5, *available at* http://www.ftc.gov/os/comments/marketmanipulation3/541354-00003.pdf. ("[C]ompanies may prefer to disclose no information, instead of risking violating the rules prohibition on omissions").

130. *Prohibitions on Market Manipulation, supra* note 6, at 40,698.

actor knew or must have known that the omission caused a statement to be false. Second, subpart (b) contains a limiting proviso that the omission distort, or be likely to distort, market conditions for any covered product.

1. Appropriate Scienter

The first way by which the Commission addressed concerns about regulatory overreach and business uncertainty about the scope of section 317.3(b) was to heighten the scienter standard that must be proved to find a rule violation. A violation of section 317.3(b) requires that the Commission prove that the defendant "intentionally omitted information from a statement with the further intent to make the statement misleading."[131] Significantly, the Commission states that this scienter standard applies both to the act of omitting a material fact and to the intent that the statement be misleading. Thus, merely showing that the defendant intended to omit a material fact is, by itself, insufficient to make out this element of a rule violation. The Commission must also prove that the defendant did so with the intent to be misleading. The Commission need not show, however, that the defendant intended to manipulate a wholesale petroleum market or have an impact on any market metric.[132]

These are high standards of proof to meet. They go significantly beyond the "knowingly" standard in section 317.3(a), which requires proof only that the defendant knew or must have known that his conduct would be fraudulent or deceptive, *i.e.,* evidence that the defendant was aware of the risk of that result, whether or not he intended it. By heightening the scienter standard for rule violations regarding material omissions, the Commission has significantly differentiated the two subparts of the prohibited conduct. In so doing, the Commission has indicated that, with respect to the incidence of material omissions, its evaluation of the tradeoff between enforcement flexibility and the potential for adverse effects on the voluntary disclosure of information beneficial to smooth market functioning weighs in favor of less enforcement flexibility.

2. Market Impact

Subpart (b) of the Rule also differs from subpart (a) in that it requires that the Commission demonstrate that the alleged misleading statement, by dint of its dissemination, "distorts or is likely to distort market conditions for a covered product." The SBP states that proving this element of an offense does not require evidence of a specific price effect or a specific effect on any other market metric.[133] Instead, according to the SBP, the Commission need show only that the misleading statement is of the character likely to distort the data available to the market.[134] In

131. *Id*.

132. *Id*. at 40,699.

133. *Id.* ("[T]he phrase 'distorts or is likely to distort market conditions' speaks only to the ability of market participants to rely on the integrity of market data in making purchase and sales decisions").

134. *Id.*

other words, although there is no burden on the Commission to prove a specific, quantifiable market effect, a court must nonetheless be able to conclude that the challenged conduct has had, or is likely to have if not enjoined, some kind of adverse impact on a relevant wholesale petroleum market.

Subpart (b)'s limiting proviso raises a number of questions. First, what is the justification for the inclusion of a market conditions requirement? Second, how might the market requirement be proved by evidence short of a demonstration of a specific, quantifiable price effect? Third, what is meant by "distort or is likely to distort market conditions" if that is not a showing of a specific, quantifiable price effect? In other words, what are the attributes of conduct that would permit a court to conclude that the proviso is satisfied?

a. Justification for the Inclusion of the Market Conditions Proviso

Relying on the framework of SEC Rule 10b-5, the Commission's initially proposed rule contained three subparts, the second of which would have prohibited omissions of material facts.[135] Neither that subpart, nor either of the other two for that matter, contained a market impact proviso. The proviso was added only later when the Commission published its revised proposed rule.[136] At that time, the Commission collapsed the proposed rule into two subparts – a subpart prohibiting overt fraud and deception and a subpart prohibiting omissions of material facts. The Commission added the market impact proviso only to the omissions subpart, however. Specifically, revised proposed rule subpart (b) prohibited statements made misleading by reason of an omission of a material fact only insofar as the omission "distorts or tends to distort market conditions for a covered product." The final rule is almost identical, except that the limiting proviso was modified to read "distort or

135. *NPRM*, *supra* note 75, at 48,334. The initially proposed rule stated:

> 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,
>
> (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 the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person. (The wording is virtually identical to SEC Rule 10b-5).

136. *RNPRM*, *supra* note 78, at 18,328. The revised proposed rule stated:

> 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:
>
> (a) Knowingly engage in any act, practice, 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; or
>
> (b) 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 tends to distort market conditions for any such product.

is likely to distort market conditions for a covered product." The Commission says in the SBP that this modification is non-substantive.[137]

The addition of the proviso to subpart (b) seems to be a consequence of the Commission's concern that, absent a market impact limitation, uncertainty about the potential reach of subpart (b) would raise an unacceptable risk of disrupting legitimate business conduct.[138] Indeed, a number of commenters and public workshop participants noted that the underlying purposes of SEC Rule 10b-5 and section 811 of EISA are substantively different, and that those substantive differences argue compellingly for a different level of concern about misleading statements in the two contexts.[139]

The basis for these contentions is that wholesale petroleum markets are markets in which participants on both sides of a transaction are typically sophisticated commercial actors generally able to assess the accuracy of statements and who likely have the resources to fill any important informational gaps. The parties are accustomed to dealing with one another, and most firms are ongoing enterprises with long term reputations to protect.

By contrast, a goal of securities law is to protect the individual investor in securities. That investor may, in some instances, possess less complete information than, *e.g.*, a securities broker, and may also be significantly less able to discern relevant information gaps, let alone have the resources to fill those gaps. For that reason, the long history of securities law enforcement has generated a body of case law defining the boundaries of what is a material fact in the context of securities transactions.[140] Professionals generally know, or should know, what must be provided to investors, and what may be omitted, in order to remain within the law.

In the context of wholesale petroleum market transactions, it is less clear what information a party should be legally compelled to provide to a counterparty. For example, routine bilateral business negotiations between buyers and sellers often entail the strategic holding back of certain information as part of the negotiation process whereby each party seeks to obtain its best bargain. In some instances, the information may never be disclosed; in other instances, disclosure of the information may be used as a bargaining chip to be traded for one or more concessions

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137. *Prohibitions on Market Manipulations*, *supra* note 6, at 40,699 ("The Commission has effected this modification in order to eliminate the possibility of confusion, by clarifying that final Rule Section 317.3(b) focuses upon those material omissions that are likely to distort market conditions").

138. *Id.* at 40,699, which states:

> The Commission has concluded that the limiting proviso advances the effective implementation of Section 811 in an important way. It ensures that Section 317.3(b) prohibits only those material omissions that can be expected to manipulate a wholesale petroleum market. In so doing, it gives market participants the certainty that statements containing material omissions will not be challenged if they do not adversely threaten the reliability of data in a broader wholesale petroleum market.

139. *See, e.g.*, Public Workshop Testimony of Robert Long on Behalf of API, at 19-21, 34; Public Workshop Testimony of Susan DeSanti on Behalf of NPRA, at 250.

140. *See, e.g.*, THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION (5th vol. 2005) at 277-333, "Materiality in Rule 10b-5 Actions" and accompanying footnotes citing relevant case law.

from the counter party. Such conduct should not be discouraged; it is part of profit-maximizing, competitive conduct. When information is valuable, firms have an incentive to acquire more information, thus enhancing economic efficiency. At a minimum, the absence of clear cut rules and the absence of a history of judicial guidance argue for caution in attempting to identify "omissions" that are properly prohibited by subpart (b).

Absent some limits, a blanket prohibition on omissions could give rise to substantial uncertainty among business decision-makers as to what potentially could be subject to litigation risk. At the least, it would significantly alter the tenor of bilateral contract negotiations, potentially reducing the number of otherwise wealth-generating transactions in order to mitigate perceived litigation risk. Moreover, if the industry commenters are correct about the complexity of wholesale petroleum markets, a blanket prohibition also would risk a high incidence of enforcement error due to misdiagnosis of harmful conduct, leading both the Commission and the defendant to deploy resources wastefully.[141]

Given these concerns, limiting prohibitions on omissions of material facts to those instances that can be expected to distort the data available to the market at large, and thus adversely affect decision making throughout the relevant market, prudently keeps the Commission from injecting itself into normal, routine, bilateral negotiations or second-guessing parties' strategies within those settings. The SBP thus states that "the Commission does not generally intend that section 317.3(b) reach routine bilateral commercial negotiations, which are unlikely to inject false information into the market process."[142] In principle, of course, under special circumstances, misleading statements made in the context of bilateral negotiations could reach sufficiently far to have distortionary effects in the larger market, but these would be exceptional. Thus, subpart (b) does not altogether exclude challenges in such situations, but the limiting proviso, for all intents and purposes, provides the business community with the assurance that the final rule will not interfere with ordinary business conduct. On balance, inclusion of the proviso in subpart (b) focuses enforcement on preventing undesirable market manipulation, while it simultaneously limits the possibility of regulatory error.

b. Causation Short of a Specific Price Effect

In the SBP, the Commission states that finding a violation of subpart (b) does not require that the Commission prove a specific price movement or other market effect.[143] That is, the evidentiary burden that the proviso

141. The Commission agreed that such enforcement error would risk creating social costs if otherwise wealth-generating activities are curtailed by businesses in order to mitigate litigation risk. However, as discussed below, it did not feel that a price effect was a necessary component of the omissions section, noting that the market conditions proviso "achieves the objectives of Section 811 while limiting interference with legitimate business activity." *Prohibitions on Market Manipulation*, *supra* note 6, at 40,699.

142. *Id.* at 40,698.

143. *Id.* at 40,699 (explaining that "Significantly, however, by the proviso's own terms, establishing a final Rule Section 317.3(b) violation does not require proof of a specific price effect").

imposes falls short of evidence that the offending statement caused a specific effect in the market that can be traced back to the challenged conduct. Such evidence is not only not required by section 811, but requiring it would be unwise as a matter of sound policy.

Section 811 is silent on the issue of price or market effects, and thus plainly does not compel proof of such effects for a statutory or rule violation.[144] Nor does the statute preclude the Commission from including a market impact element within the final rule. Given this flexibility, a showing that the challenged conduct is likely to have some kind of adverse market impact is appropriate for subpart (b) for the reasons discussed above. Nevertheless, a showing of a specific market effect traceable to the challenged conduct is not needed to cabin the reach of the subpart effectively, and to require such a showing would impracticably make the subpart largely impotent.

In making purchase and sales decisions, market participants observe the data that are available to the market at any given time. Those data, in turn, permit market participants to make rational decisions given their individual economic objectives. The better the data, the more likely those objectives will be achieved. In making marketplace decisions, buyers and sellers are entitled to presume that the data reflect underlying market fundamentals and have not been tainted by fraudulent or deceptive conduct. Intentionally misleading statements that reach the larger market thus cast into doubt the very information that allows markets to function properly. They distort the signals that drive market participants and introduce added frictions into the price discovery process.[145]

Two factors then are key to showing a market impact from material omissions. First, the misleading statement must concern information that is incorporated into market data. That is, it concerns information that affects the parameters that determine underlying market fundamentals. This step, in most instances, should not be difficult to show. Second, however, the statement made misleading by reason of the omitted material

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144. Energy Independence and Security Act (EISA), 42 U.S.C. §§ 17301-17305 (2006) (stating, "It is unlawful . . . to use or employ . . . any manipulative or deceptive device or contrivance").

145. Markets function best when market participants can presume that observable market prices have incorporated all relevant data about underlying market fundamentals. Exchanges among market participants on that basis help markets to adjust from disequilibrium states by accelerating the movements of price and output rates to positions that balance supply and demand. Efficiently functioning markets are those that equilibrate as rapidly as possible in light of the introduction of new data that alter market fundamentals.

The injection of false or misleading data into a market distorts the price signals that drive the equilibration process and thus delays or impedes that process. In such situations, observable prices on which decision-makers act do not convey accurate signals about underlying demand and supply conditions. At a minimum, short-term purchase and sale decisions can be expected to be distorted. In addition, depending on the duration of the incorrect price signals, longer-term capital investments undergirding future output also may be adversely altered. In all cases, the efficiency of the market equilibration process is impaired.

The adverse effects from injecting false or misleading data into the market may be further exacerbated if, for example, wealth-generating exchanges fail to take place because of dissemination of misinformation that is relied on, even if relied on by only a small proportion of market participants. In addition, if fraudulent or deceptive conduct is recurrent, market participants may have to invest scarce resources into defensive measures. Such investments, although perceived as necessary by the investor, are socially wasteful because they utilize resources that otherwise might have been allocated to wealth-generating activities.

fact must find its way, or be likely to find its way, to the market at large. That is, if the statement is not disseminated to the market and the deception and its effect are localized to the transacting parties, there cannot be a market impact. Showing this factor thus requires evidence of the misleading statement's broader dissemination, though that dissemination need not be intended or executed by the alleged violator. Once there is evidence from which a court can conclude that these two factors prevail, subpart (b)'s proviso is satisfied. Further evidence of a specific, traceable effect on some particular datum adds no further cause for concluding that a manipulative market impact has occurred.

Indeed, in addition to being unnecessary, as a practical matter, requiring that the Commission trace specific price or market effects to misleading statements would result in an insurmountable evidentiary burden in many, if not most, enforcement actions. The Commission's long experience in studying petroleum products markets, as well as its antitrust enforcement efforts in those markets, reveals that price movements largely result from a multitude of interacting variables.[146] That is, observable prices at any given moment are determined by many parameters having differing impacts and interacting with each other simultaneously. In this complex marketplace setting, it is, at a minimum, practically difficult, and sometimes impossible, to disentangle the specific contribution of each causal factor contributing to a specific price movement.[147] Moreover, attempts to do so are often fraught with significant risk of specification and measurement error and thus lend themselves, in a litigation environment, to a variety of methodological attacks.[148]

If the Commission were thus required to produce such evidence of a specific effect in order to prove a violation of the subpart (b), its enforcement efforts would likely be substantially handicapped. At a minimum, fending off methodological attacks on the Commission's econometric estimates would delay litigation outcomes and, at worst, may prevent the Commission from halting harmful manipulative conduct. At the same time, placing such a burden on the Commission would not offer offsetting benefits because the harm from the manipulative conduct comes from calling into question the integrity of the market data, not from any specific effect on a market metric.

146. FTC, GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (2005).

147. *See, e.g.*, James D. Hamilton, *Understanding Crude Oil Prices*, 30 ENERGY J. 179 (2009).

148. That is not to say, however, that one cannot appropriately predict that an event or the injection of information into the marketplace will have an impact on prices. For example, the Commission has successfully challenged several horizontal mergers in petroleum markets on the basis that the merger would contribute to future price increases. That is, even if other factors would cause prices to go up anyway, the merger would make them go up more than they otherwise would have. Here it is not necessary to isolate the merger's likely specific contribution to post-merger price increase; rather, it is only necessary to show that the merger will likely make some non-trivial anticompetitive contribution to future price movements. *See, e.g.*, Exxon/Mobil Corp., Application for Approval of Proposed Base Oil Supply Contracts, C-3907 (Jan. 26, 2001) (final consent order) (acquisition would raise retail gasoline prices). The same reasoning applies to predicting a market impact from the injection of false or misleading information into the marketplace.

c. "Distorts or is Likely to Distort Market Conditions" Requires an Impact on Market Fundamentals

The SBP states that section 317.3(b)'s limiting proviso "gives market participants the certainty that statements containing material omissions will not be challenged if they do not adversely threaten the reliability of data in a broader wholesale petroleum market."[149] The SBP further explains that "the core principle embodied in the proviso centers around the character and the likely market reach of the false or misleading information that is injected into the market by means of misleading statements. Specifically, establishing a violation of final rule section 317.3(b) requires showing that the character and likely market reach of such false or misleading information is likely to make market data less reliable."[150]

Notably absent from this explanation is the concept of market power or competitive effects. Market power in the traditional antitrust context is not the concern of the final rule.[151] Instead, the market impact that is of concern is the effect of the misleading statement on the ability of market participants to make informed evaluations of market fundamentals and make transaction decisions based on those evaluations, confident that the fundamentals have not been artificially distorted by fraud or deception. In short, it is an adverse impact on the integrity of the market process that is the focus of the limiting proviso.

As such, the misinformation at issue must be information pertaining to those factors that determine demand and supply conditions (*i.e.*, market fundamentals) in some covered wholesale petroleum market.[152] Such information ultimately determines market prices, which are the signals that guide market participants. Thus, for example, misinformation about prices, costs, inventories, shipping plans, output rates, or current available capacity is likely to be of the "character" that would threaten market integrity if the misinformation penetrates the market. By contrast, statements that may mislead individual buyers or sellers but whose

149. *Prohibitions on Market Manipulation*, *supra* note 6, at 40,699.

150. *Id.*

151. By contrast, in the futures markets context, the more traditional idea of "market power" may be useful. According to one commenter, the most important form of manipulation in commodity markets in general, and petroleum markets in particular, is related to the exercise of market power intended to enhance the profitability of derivatives positions. For instance, in a classic "corner" or "squeeze" the holder of a large long derivatives position on delivery settled contracts demands an inefficiently large number of deliveries against these contracts. Those who have entered into contracts obligating them to make delivery are forced with the choice of incurring supercompetitive costs to make the inefficiently large deliveries, or paying a supercompetitive price to the large long to buy back their contracts. Although the large long incurs a loss from taking excessive deliveries (this is referred to as the cost of "burying the corpse" of the manipulation), he profits from liquidating a sufficiently large number of contracts at the supercompetitive price. This strategy represents an exercise of market power. The large long is not a price taker. Instead, by dint of his large derivatives position, he is a price maker who can affect prices through his delivery decisions (internal footnotes and paragraphing omitted). Testimony of Craig Pirrong, NPRM Comment (Nov. 5, 2008) at 3, *available at* www.ftc.gov/os/comments/marketmanipulation2/538416-00018.pdf.

152. In economic terms, the information must relate to the principal independent variables in the relevant demand or supply schedules.

substantive content is not likely to be absorbed into market data would not be of the "character" likely to threaten market integrity.

Depending upon the specific circumstances of a particular market environment, some forms of misinformation may not always be readily identifiable as affecting market fundamentals. In such cases, the Commission may have to produce a higher quantum of evidence to show that the proviso is satisfied. This evidence might be in the form of expert opinion evidence, the testimony of traders and other market participants, or statistical analysis.

In addition to being of the "character" likely to threaten market integrity, the misinformation must also reach the larger market sufficiently to be absorbed into market data. Localized dissemination or impact would not satisfy the proviso. Here again, various types of evidence could be adduced to meet this burden, including expert opinion and market participant testimony. Evidence showing a broadcast of the misleading statement to the larger market, *e.g.*, a public announcement or insertion into industry channels such as brokers and traders, should also meet the test.

In the SBP, the Commission identified several kinds of conduct that might qualify as a material omission triggering section 317.3(b). If a trader routinely reported price, production, or inventory information to a private reporting service that provides data to the marketplace, while intentionally omitting facts that would show that data to be false, the market conditions proviso would be satisfied.[153] Omitting material information to government officials in an attempt to mislead them would similarly be covered by the market integrity language, since the market typically relies on such data for trading purposes.[154]

VI. CONCLUSION

With the passage of the EISA, Congress made clear its intent that the Commission promulgate an anti-manipulation rule for wholesale petroleum markets based on the 10b-5 jurisprudence developed by the SEC and the courts and later similar enforcement from both the FERC and the CFTC. The Commission has crafted a rule similar to those existing efforts, but tailored to account for the specific attributes of wholesale petroleum markets.

The Commission justified its promulgation of the market manipulation rule on the basis that it is appropriate to prohibit fraudulent and deceptive conduct, and the final rule attempts to reach that objective while imposing minimum costs. A regulation satisfying good public policy criteria should minimize the sum of costs attendant to (1) failure to challenge harmful conduct successfully and (2) regulatory overreach that chills benign or beneficial conduct. If harmful conduct is found to be widespread, an ineffectual rule will result in a net harm to social welfare. By contrast, if harmful conduct is rare, the existence of a costly social

153. *Prohibitions on Market Manipulations*, *supra* note 6, at 40,699.

154. *Id.*

mandate may chill beneficial economic activity as firms attempt to limit litigation risk in the face of uncertainty over the application of the rule. The final Commission rule appears to address these concerns by providing for greater ease in proving a rule violation for outright fraud or lying than for proving a violation for misleading material omissions.

It of course remains to be seen whether the Commission has chosen the correct balance to provide a net benefit to the efficient functioning of wholesale petroleum markets. However, experience to date with other federal anti-manipulation enforcement efforts indicates on-going concerns about fraudulent activity in important markets, including energy markets, and the seriousness with which the Congress, courts, and the regulatory agencies have moved against it. The careful balancing of costs and benefits apparent in the Commission's rulemaking process gives hope that the Commission's enforcement of the final rule will enhance the perceived integrity of wholesale petroleum markets.