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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Wholesale Petroleum Buyers, Sellers — Beware

Law360, New York (December 01, 2009) -- A new Federal Trade Commission rule, commonly known as the FTC Market Manipulation Rule, took effect on Nov. 4, 2009, and could lead to the imposition of major fines on sellers or buyers at wholesale of crude oil, gasoline, jet fuel and petroleum distillates for either knowingly misleading conduct or statements or intentionally failing to state material information in connection with statements by such sellers and buyers.

As the FTC states, the rule seeks to prohibit “market manipulation — that is, fraudulent or deceptive acts, practices or courses of business — in the wholesale petroleum industry.”[1]

The FTC has enforcement authority and can issue civil penalties up to \$1 million per day per violation of the rule.

Text of FTC Rule

The new FTC rule makes it unlawful for any person or entity, directly or indirectly, in connection with the wholesale purchase or sale of crude oil, gasoline, jet fuel or petroleum distillates from:

(a) Knowingly engaging 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 failing 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.[2]

Products and Situations Covered by the FTC Rule

The key to understanding what entities, products and activities are covered and prohibited by the rule is found through an examination of the rule's definitions and comments sections.

As required by Section 811 of Subtitle B of Title VIII of the Energy Independence and Security Act of 2007 ("EISA"),[3] the FTC rule applies to pipeline companies and their owners and affiliates to the extent their actions exceed acting solely as common carriers governed by the Interstate Commerce Commission.[4]

The term "wholesale" includes all purchases or sales of (1) crude oil or jet fuel (even if not for resale); and (2) gasoline or petroleum distillates (other than jet fuel) including terminal rack sales, but does not extend to retail sales of gasoline, diesel fuels or fuel oils to consumers.[5]

The FTC intends the rule to reach renewable fuels sold at wholesale (e.g. ethanol or biodiesel) or blending components (e.g. alkylate or reformate) that are not specifically identified in the definitions[6] only if there is sufficient nexus between conduct involving those products and wholesale petroleum markets for the covered products.[7]

The FTC does not intend the rule to apply to commodities whose predominant use is nonpetroleum products, or to commodities that are inputs for ethanol, such as corn or sugar.[8]

What is "Knowing" Conduct?

The FTC set a high standard of "scienter" in the rule that will make it difficult for a person or entity to violate the rule innocently or inadvertently.

Specifically, to violate the rule, a person must engage in the proscribed conduct "knowing that it is fraudulent or deceptive." [9]

"For example, a trader's state of mind must encompass more than just carrying out the ministerial function of transmitting false information to a price reporting service. Rather, there must be evidence that the trader knew or must have known that the information transmitted was false." [10]

Liability is established, however, if the trader acted at the behest of another person within the same organization "who knew or must have known" that the conduct would operate as a fraud or deceit. [11]

Notwithstanding, the FTC "does not intend that the requisite state of mind be imputed across persons within an organization." [12]

The FTC does not intend the rule to cover inadvertent mistakes, unintended conduct or legitimate conduct in the ordinary course of business, and thus, for enforcement

purposes, the FTC has determined that a showing of “extreme reckless is, at a minimum, necessary to prove the scienter element.”[13]

The rule does not impose an affirmative duty to disclose information or a duty to correct or update information. Similarly, it is not a violation of the rule to withhold market intelligence that a company gathered about market conditions.[14]

Also, the rule does not impose any recordkeeping requirements,[15] although entities may want to review their document retention policies to position themselves to defend against asserted violations of the rule.

No Preemption of State Laws

The rule contains a standard preemption provision that is found in other FTC rules, making it clear that the FTC does not intend to preempt the laws of any state or local government, except to the extent of conflict.[16]

Parallels in Other Agency Rules

The new FTC rule is intended to “prevent the same types of fraudulent or deceptive practices that the U.S. Securities and Exchange Commission,[17] the Commodity Futures Trading Commission,[18] and the Federal Energy Regulatory Commission have pursued in the markets they respectively regulate.”[19]

The FERC, for example, acting pursuant to The Energy Policy of 2005,[20] adopted regulations that address market manipulation in the natural gas and electricity markets.

Those regulations make it unlawful for “any entity, directly or indirectly, in connection with the purchase or sale of natural gas [or electric energy] or the purchase or sale of [natural gas] transportation [or electric transmission] services subject to the jurisdiction of the [FERC]” to:

- “Use or employ any device, scheme or artifice to defraud;
- 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
- Engage in any act, practice or course of business that operates or would operate as a fraud or deceit upon any entity.”[21]

Although the text of the FERC’s market manipulation regulations do not match certain elements of the new FTC rule which includes “Knowingly engage in any act” or “Intentionally fail to state a material fact,” the FERC has made it clear that “there can be no violation of [these market manipulation regulations] ... absent a showing of the requisite scienter.”[22]

The EISA authorizes the FTC to impose civil penalties of \$1 million per day per violation of the new FTC rule.[23] The FERC has similar \$1 million per day per violation civil penalty authority.[24]

The FERC aggressively enforces market manipulation. In 2009, the FERC has settled allegations of manipulation and fraud by agreeing to payments as much as \$30 million.

The FERC has issued policy statements to apprise the energy industry of how the FERC views and intends to carry out its market manipulation authority.

The policy statements discuss audits, investigations, discovery, settlements, treatment of self-reporting and choice of remedies including disgorgement of profits, compliance plans, nonmonetary measures (such as conditioning, suspending or revoking authority to sell the FERC-regulated product) and civil penalties.[25]

Entities seeking some indication of how the FTC rule may be applied and enforced could look to the application of the FERC rules for guidance.

Conclusion

Persons and entities that engage in the wholesale sale or purchase of crude oil, gasoline, jet fuel and petroleum distillates should be mindful of the new rule that became effective Nov. 4, 2009, and educate their employees accordingly.

The rule establishes a high bar for “knowing” and “intentional” conduct and statements, and thus persons and entities generally need not be concerned with innocent or inadvertent conduct in releasing false information.

The more problematic provision in the rule, however, may be the failing to state material information that renders statements made by such persons or entities misleading, where the omission is likely to distort market conditions for these products.

Companies will need to monitor FTC proceedings closely to learn what the FTC considers an omission of material information leading to distorted market conditions.

Companies may benefit from reviewing FERC compliance programs as a means to put internal measures in place to ensure compliance with the new FTC rule.

--By Bradley C. Weber (pictured), Paul C. Van Slyke, Gregory T. Casamento and Bruce Grabow, Locke Lord Bissell & Liddell LLP

Bradley Weber is a partner with Locke Lord Bissell & Liddell LLP in the firm's Dallas and Washington, D.C., offices and co-chair of the firm's antitrust litigation practice group. Paul Van Slyke and Gregory Casamento are both partners with the firm in the Houston and New York offices, respectively. Bruce Grabow is an attorney in the firm's Washington, D.C., office.

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[1] Federal Trade Commission, Market Manipulation Rule, www.ftc.gov/ftc/oilgas/rules.htm (last visited Nov. 5, 2009).

[2] Prohibitions on Market Manipulation, 74 Fed. Reg. 40,686, 40,686.

[3] 42 U.S.C. § 17301 (2007).

[4] Prohibitions on Market Manipulation, 74 Fed. Reg. at 40,691.

[5] FTC Market Manipulate Rule, 16 C.F.R. § 317.2(f) (2009); Prohibitions on Market Manipulation, 74 Fed. Reg. at 40,692. Under the Rule, the term “petroleum distillate” includes, but is not limited to, jet fuels, diesel fuels and fuel oils. 16 C.F.R. § 317.2(e). The term “gasoline” means finished gasoline, including but not limited to, conventional, reformulated, and oxygenated blends and conventional and reformulated blendstock for oxygenate blending. *Id.* at § 317.2(b).

[6] Prohibitions on Market Manipulation, 74 Fed. Reg. at 40,691.

[7] *Id.* at 40,696.

[8] *Id.* at 40,695. The term “crude oil” includes, but is not limited to, any mixture of hydrocarbons that exists in liquid phase in natural underground reservoirs and that remains liquid at atmospheric pressure after passing through separating facilities and as shale oil or tar sands requiring further processing for sale as refinery feed stock. 16 C.F.R. § 317.2(a).

[9] *Id.* at § 317.3(a).

[10] Prohibitions on Market Manipulation, 74 Fed. Reg. at 40,696.

[11] *Id.*

[12] *Id.* at 40,696 n.128.

[13] *Id.* at 40,691.

[14] *Id.* at 40,698.

[15] *Id.* at 40,693.

[16] 16 C.F.R. § 317.4; Prohibitions on Market Manipulation, 74 Fed. Reg. at 40,700.

[17] See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b); 17 CFR 240.10b-5.

[18] See Commodity Exchange Act § 9(a)(2), 7 U.S.C. § 13(a)(2).

[19] Prohibitions on Market Manipulation, 74 Fed. Reg. at 40689.

[20] Pub. L. No. 109-58, 119 Stat. 594 (2005) (EPAAct 2005) (amending, as applicable here, the Federal Power Act (FPA) and the Natural Gas Act (NGA)).

[21] See 18 C.F.R. §§ 1.c.1—.2 (2009).

[22] Prohibition of Energy Market Manipulation, 114 FERC ¶ 61,047 at P 45 (2006). The FERC also has adopted Market Behavior Rules that require sellers of electricity products at wholesale in interstate commerce to operate and schedule generating facilities ... and commit or otherwise bid supply [in organized electricity markets] in a manner that complies with the [FERC]-approved rules, ... provide accurate and factual information and not submit false or misleading information, or omit material information, in any communication with the [FERC], and [FERC]-approved market monitors, [and] regional transmission organizations, ... provide accurate and factual information, and not knowingly submit false or misleading information or omit material information to any ... publisher[s of electric or natural gas price indices, and] retain, for a period of five years, all data and information upon which it billed the prices it charged for the ... electric energy products it sold ... and the prices it reported for use in price indices. 18 C.F.R. § 35.41(a)-(d).

[23] See 42 U.S.C. § 17304.

[24] See 15 U.S.C. § 717t-1 (NGA); 16 U.S.C. §§ 825o-1, 823b (Part II of the FPA); 15 U.S.C. § 3414(b)(6) (Natural Gas Policy Act of 1978).

[25] See Revised Policy Statement on Enforcement, 123 FERC ¶ 61,156 (2008); Policy Statement on Compliance, 125 FERC ¶ 61,058 (2008).