

Preventing Fraud in the Oil Patch: FTC Issues Final Market Manipulation Rule

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The Federal Trade Commission issued a petroleum market manipulation rule that contains anti-fraud standards. The authors of this article discuss the new rule and advise petroleum industry participants to develop internal procedures and protocols designed to minimize the chance of any rule violations, inadvertent or otherwise.

On August 6, 2009, the Federal Trade Commission (“FTC”), on a 3-1 vote, issued its petroleum market manipulation rule that contains anti-fraud standards based in large part on Securities and Exchange Commission (“SEC” or the “Commission”) Rule 10b-5.¹ The rule, which has been in process for over a year and will become effective on November 4, 2009, outlaws fraudulent and deceptive practices in the wholesale markets for crude oil and refined products.² Violations can result in penalties of up to \$1 million per violation per day (in addition to any relief available under the FTC Act).³ Petroleum industry participants need to carefully examine their practices and procedures, and internal controls, to assure that they will be on the right side of the rule come November.

In a statement issued in conjunction with the rule, FTC Chairman Leibowitz described the rule as “a broad anti-fraud measure that will help us prohibit conduct that harms consumers but that may not violate antitrust laws.”⁴ Chairman Leibowitz said that the Commission will “use this authority as aggressively as possible to stop market manipulation that drives up prices at the pump.”⁵

Commissioner (and former Chairman) Kovacic voted against the rule and issued a dissenting statement in which he expressed concern that the rule will cover “a vast number of routine transactions” and that there is “a serious danger that it will impede routine contracting that is benign or procompetitive.”⁶ Noting that the “FTC’s previous inquiries have determined that price fluctuations for petroleum products result principally from market forces,” Commissioner Kovacic questioned the benefits of a market manipulation rule and indicated that, at minimum, the rule should have been more narrow.⁷ Commissioner Rosch issued a statement noting that he agrees with Commissioner Kovacic’s misgivings about the rule, but that he believes the rule is consistent with congressional intent.⁸ Commissioner Rosch stated, however, that in exercising prosecutorial discretion under the rule he intends to keep those misgivings in mind.⁹

PROHIBITED PRACTICES

The FTC’s petroleum market manipulation rule, 16 CFR § 317.3, makes it unlawful for:

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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 on 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.¹⁰

Thus, there are less stringent *scienter* requirements under the rule for affirmative acts than there are for omissions. A violator must act “knowingly” with respect to affirmative acts, but “intentionally” with respect to omissions.

Affirmative Actions

“Knowingly” is expressly defined in the rule to mean “that the person knew or must have known that his or her conduct was fraudulent or deceptive.”¹¹ This standard is intended to embody the “extreme recklessness” standard articulated by the Seventh Circuit in the SEC context. The adoption of a recklessness standard had been among the most hotly contested issues in the rulemaking. Although the FTC has modified the *scienter* language in Section 317.3(a) from that contained in the Revised Notice of Proposed Rulemaking (“RNOPR”), the change was intended only to avoid confusion and not to change the standard.¹² The Commission did, however, clarify that it does not intend to adopt 7th Circuit precedent that recklessness can be demonstrated by a showing of “an extreme departure from the standards of ordinary care” because standards of ordinary care are not as well-developed in the petroleum markets as they are in securities markets.¹³

Omissions

For an omission to be actionable under the market manipulation rule, the alleged violator must have had an intent to mislead by intentionally omitting material

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facts.¹⁴ The Commission adopted this higher *scienter* standard for omissions in an effort to avoid chilling legitimate business activity.¹⁵ There is, however, no requirement to show that the actor actually intended to manipulate or affect a market.¹⁶ Nor is there a requirement of an actual price effect.¹⁷

The rule also requires a showing that an omission “distorts or is likely to distort market conditions” for a covered product before it is actionable.¹⁸ This requirement is intended to respond to concerns that liability for omissions could chill voluntary disclosures of information. The Commission stated that it believes the language it has adopted strikes an “appropriate balance between the needs of effective enforcement and unduly burdening legitimate business practices.”¹⁹

MATERIALITY

Under the FTC’s rule, a fact is “material” if a reasonable market participant would consider it important in making a decision to transact business because such information materially alters the total mix of information available. This is the traditional formulation of materiality used in the SEC Rule 10b-5 context. The FTC intends to evaluate materiality on a case-by-case basis.²⁰

REACH OF THE RULE

The new market manipulation rule is applicable to any person within the FTC’s jurisdiction.²¹ However, it is limited to actions taken “in connection with” “wholesale” transactions, defined as “(1) all purchases and sales of crude oil and jet fuel; and (2) all purchases or sales of gasoline or petroleum distillates (other than jet fuel) at the terminal rack or up-

stream of the terminal rack level.”²² The rule is not applicable to retail sales to consumers.

The “in connection with” language is to be construed broadly.²³ This language extends the reach of the rule to conduct beyond the actual purchase and sale of covered products if that conduct directly or indirectly impacts the wholesale prices of covered products. For example, an enforcement action could involve additives or biofuels.²⁴ However, the rule is not intended to cover commodities that are inputs to ethanol, like corn and sugar.²⁵ The Commission also has been clear that the rule could reach supply or operational decisions where there is a sufficient nexus between the conduct at issue and the purchase or sale of a covered product.²⁶ The Commission will make these determinations on a case-by-case basis.

TYPES OF PROHIBITED CONDUCT

The FTC gave as examples of conduct that would violate Section 317.3(a): “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 dissemination of false information to the broader market; and fraudulent or deceptive conduct such as wash sales.”²⁷ Addressing concerns raised by many commenters, the Commission stated that it “generally does not intend to reach bilateral negotiations as a matter of course,” since such conduct can more appropriately be addressed under state law.²⁸ The Commission also clarified that Section 317.3(a) would not reach omissions, which are covered exclusively by Section 317.3(b).²⁹

The FTC did not include examples of activities that would violate Section 317.3(b), but did note that the provision imposes no affirmative duty to disclose information or a duty to correct or update information.³⁰ Subsection (b) applies only if an entity voluntarily provides information or is compelled to provide information pursuant to a statute, order or regulation and “intentionally fails to disclose a material fact that makes the information misleading.”³¹

According to the Commission, the rule is not intended to cover “inadvertant mistakes, unintended conduct, or legitimate conduct undertaken in the ordinary course of business.”³² As noted, however,

Commissioner Kovacic and Commissioner Rosch are concerned that the rule will reach such conduct, or will chill conduct that is procompetitive.

OTHER CONSIDERATIONS

The FTC rejected arguments that it should adopt a safe harbor for futures market activities in deference to the Commodities Futures Trading Commission’s (“CFTC”) exclusive jurisdiction over futures markets.³³ Accordingly, the FTC’s market manipulation rules will apply to conduct in futures markets if that conduct affects the physical market. The FTC reiterated its intent to cooperate with the CFTC, but did not specify what this cooperation will entail and did not, for example, discuss how, if at all, the FTC will take into account the CFTC’s ongoing, broad-ranging

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audits of crude oil trading.³⁴

Among the issues left open by the proposed rule is whether a private right of action for manipulation might be inferred, as it has been in the securities context. In the RNOPR, the FTC noted that the Energy Independence Security Act of 2007 (“EISA”) does not expressly create private right of action but stated that whether or not such a right can be implied is an issue for the courts, not the FTC.³⁵ In his dissenting statement, Commissioner Kovacic expressed concern that the rule would become the subject of litigation in state courts under state consumer protection laws, and Commissioner Rosch stated that “it would be especially unfortunate if the Rule were interpreted or applied so as to permit follow-on private actions.”³⁶

CONCLUSION

While the FTC can now triumphantly report to Congress that it has duly adopted a tough market manipulation rule, the amount of resources the Commission will throw into investigations and enforcement

remains to be seen. When the rule becomes effective in November, will the agency launch a market manipulation strike force to affirmatively police energy markets? Or will it proceed more in a reactive mode, investigating only in response to complaints from Congress and others? Whatever the FTC's approach, petroleum industry participants need to take heed of the new rule and develop internal procedures and protocols designed to minimize the chance of any rule violations, inadvertent or otherwise.

NOTES

¹ Federal Trade Commission, Prohibition On Market Manipulation in Subtitle B of Title VII of the Energy Independence and Security Act of 2007, Final Rule, 74 Fed. Reg. 40686 (August 12, 2009).

² See Advance Notice of Proposed Rulemaking, 73 Fed. Reg. 25614 (May 7, 2008); Notice of Proposed Rulemaking, 73 Fed. Reg. 48317 (August 19, 2008); Revised Notice of Proposed Rulemaking, 74 Fed. Reg. 18304 (April 22, 2009).

³ 42 U.S.C. § 17304.

⁴ Statement of Chairman Leibowitz, Crude Oil Price Manipulation Rule Making, Project No. P082900 at 1.

⁵ *Id.*

⁶ Dissenting Statement of Commissioner William E. Kovacic, Crude Oil Price Manipulation Rule Making, Project No. P082900 at 1.

⁷ *Id.* at 2.

⁸ Concurring Statement of Commissioner J. Thomas Rosch, Crude Oil Price Manipulation Rule Making, Project No. P082900.

⁹ *Id.*

¹⁰ 16 CFR § 317.3. The rule was issued pursuant to Section 811 of the Energy Independence Security Act of 2007 ("EISA"), 42 U.S.C. § 17301, which states that: it shall be unlawful for anyone, in connection with the wholesale purchase or sale of crude oil, gasoline, or petroleum distillates, to use any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Federal Trade Commission

may prescribe as necessary or appropriate in the public interest or for the protection of United States citizens.

¹¹ 16 CFR § 317.2(c).

¹² 74 Fed. Reg. 40691.

¹³ *Id.* at 40692.

¹⁴ *Id.* at 40698.

¹⁵ *Id.* at 40694.

¹⁶ *Id.* at 40698.

¹⁷ *Id.* at 40699.

¹⁸ This represents a minor change from the proposed rule, which used the phrase "distorts or tends to distort." The FTC made this change to avoid confusion. *Id.*

¹⁹ *Id.* at 40693.

²⁰ *Id.* at 40697.

²¹ 16 CFR § 317.1.

²² 16 CFR § 317.2(f). "Petroleum distillates" are "jet fuels, including, but not limited to all commercial and military specification jet fuels; and (2) diesel fuels and fuel oils, including, but not limited to, No. 1, No. 2, and No. 4 diesel fuel, and No.1, No. 2 and No.4 fuel oil." 16 CFR § 317.2(e).

²³ 74 Fed. Reg. at 40695.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*, note 115. The Commission made this same statement with respect to liability for omissions. *Id.* at 40698.

²⁹ *Id.* at 40696.

³⁰ *Id.* at 40698.

³¹ *Id.* Section 812 of the EISA separately imposes liability for false reporting to a government agency where there is an intent to affect government data compilation. See 42 U.S.C. § 17302.

³² 74 Fed. Reg. at 40693.

³³ *Id.* at 40691. The Commission also again rejected arguments that it should adopt a blanket exclusion for oil pipelines, which are regulated by the Federal Energy Regulatory Commission. *Id.* at 40690.

³⁴ *Id.* at 40691.

³⁵ RNOPR, 74 Fed. Reg. at 18312.

³⁶ Kovacic Statement at 2; Rosch Statement.