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A Short Guide to the Prosecution of "Market Manipulation" in the Energy Industry: CFTC, FERC, and FTC

Layne Kruse and Amy Garzon [*]

"Market manipulation" has been a potential target for U.S. prosecutors for over seventy years. However, the focus on market manipulation in the energy industry is more recent, and now the U.S. Federal Trade Commission ("FTC") has joined the Commodity Futures Trading Commission ("CFTC") and Federal Energy Regulatory Commission ("FERC") with statutory authority to police market manipulation in the energy industry. With three federal agencies, the lines of authority are far from clear. This article provides a brief guide to the statutory framework for the three agencies and explains the similarities and differences in their authority.[1]

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[1] As used in this article, the term "market manipulation" is distinguished from how the same term may be used under the antitrust laws, either as a conspiracy among competitors or as an abuse of monopoly power. "Market manipulation," as used by the CFTC and FERC, is focused on single-firm conduct, which may involve little, if any, monopoly power, as defined under the antitrust laws.

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I. COMMODITY FUTURES TRADING COMMISSION

The Commodity Futures Trading Commission, which was created in 1974, is an independent federal agency with five commissioners appointed by the President. It is specifically charged with regulating the "futures and options markets" in the United States. It prosecutes violations of the Commodity Exchange Act and commission regulations, and its focus is on maintaining the integrity of markets and protecting market users and the public from fraud, manipulation, and abusive practices.

The CFTC derives its market manipulation enforcement authority from the Commodity Exchange Act of 1936 ("CEA"). The CFTC's authority under the CEA is very broad. The CEA applies to "any commodity" and makes it unlawful for:

> Any person to *manipulate* or *attempt to manipulate* the price of *any commodity* in interstate commerce, or for future delivery … or knowingly to deliver or cause to be delivered for transmission through the mails or interstate commerce … 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.[2]

There is no definition of the word "manipulate" in this statute. The case law definition focuses on intent: "Manipulation, broadly stated, is an intentional exaction of a price determined by forces other than supply and demand"[3] and "[i]t is the intent of the parties which separates otherwise lawful business conduct from unlawful manipulative activity."[4]

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[2] 7 U.S.C. § 13(a)(2) (emphasis added).

[3] Frey v. CFTC, 931 F.2d 1171, 1175 (7th Cir. 1991) [hereinafter *Frey*]; CFTC v. Amaranth Advisors, L.L.C., --- F. Supp. 2d ----, 2008 WL 2123323, at *8 (S.D.N.Y. May 21, 2008); United States v. Reliant Energy Serv. Inc., 420 F. Supp. 2d 1043, 1056 (N.D. Cal. 2006) [hereinafter *Reliant*].

[4] In re Indiana Farm Bureau Coop. Ass'n, No. 75-14, 1982 WL 30249, at *5 (CFTC Dec. 17, 1982).

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Moreover, the courts have recognized that it is not the price that is the problem; rather, the issue is the process in which the price is set:

> The criminal manipulation provision does not criminalize the selling of a product at an unreasonable price. Rather, [it] prohibits defendants from engaging in intentional conduct aimed at preventing the basic forces of supply and demand from operating properly. [It] is concerned less with the price itself than it is with the process by which the price is set.[5]

The courts have recognized the following elements to prove price manipulation under the CEA:

1. the ability to influence price;
2. the existence of an artificial price;
3. the "cause" of the artificial price is the accused's actions; and
4. the intention to so affect the price.[6]

In its enforcement efforts in natural gas, the CFTC has focused on price reporting and natural gas trading practices.[7] The CFTC recently announced its first crude oil manipulation case, resulting from its ongoing investigation of crude oil trading. On July 24, 2008, the CFTC filed a civil enforcement action in the Southern District of New York against Optiver Holding BV, a global proprietary trading fund headquartered in the Netherlands, and two subsidiaries—Optiver US, LLC, a Chicago-based corporation, Optiver VOF, a Dutch company, and several individual defendants. The complaint

[5] *Reliant*, *supra* note 3, at 1057.

[6] *Frey*, *supra* note 3, at 1177; United States v. Radley, --- F. Supp. 2d ----, 2008 WL 2372062, at *6 (N.D. Ill. Jun. 11, 2008); *Reliant*, *supra* note 3, at 1056.

[7] *See*, *e.g.*, CFTC v. Valencia, 394 F.3d 352 (5th Cir. 2004); CFTC v. Amaranth Advisors LLC, 523 F. Supp. 2d 328 (S.D.N.Y. 2007).

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alleges that the defendants successfully manipulated certain crude oil futures contracts, causing artificial prices.[8]

II. FEDERAL ENERGY REGULATORY COMMISSION

The Federal Energy Regulatory Commission was created in 1977 to replace the Federal Power Commission. FERC, which like the CFTC also has five commissioners appointed by the President, is charged with regulating interstate transmission of electricity and natural gas in the United States.

In 2005, FERC was provided with market manipulation enforcement authority through § 315 of the Energy Policy Act of 2005 ("EPA"). The enforcement authority was expressly provided for both electricity and natural gas. The natural gas provision of the EPA, which is similar to the electric power provision, states:

> It shall be unlawful for any entity, directly or indirectly, to use or employ, in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance (as those terms are used in section 78j(b) of this title) in contravention of such rules and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas ratepayers. Nothing in this section shall be construed to create a private right of action.[9]

A year later, FERC issued Order No. 670 on January 19, 2006, which sets forth the acts and practices it considers unlawful for market manipulation. In general, FERC adopted the language from SEC Rule 10b-5 under the Securities Exchange Act of 1934. The authority given to FERC in the Energy Policy Act to prosecute market manipulation

[8] Press Release, U.S. Commodity Futures Trading Commission, CFTC Charges Optiver Holding BV, Two Subsidiaries, and High-Ranking Employees with Manipulation of NYMEX Crude Oil, Heating Oil, and Gasoline Futures Contracts (July 24, 2008) *available at*, http://www.cftc.gov/newsroom/enforcementpressreleases/2008/pr5521-08.html.

[9] Energy Policy Act of 2005, Public Law 109-58, at § 315.

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was based on the Securities Exchange Act of 1934, and thus in Order No. 670, FERC made clear that it will look to the SEC precedents on a case-by-case basis. It also expressly declared that scienter is a required element of any case brought under its market manipulation authority. In particular, the rule for natural gas provides as follows:

> (a) It shall be unlawful for any entity, directly or indirectly, in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission,
>
> (1) To use or employ any device, scheme, or artifice to defraud,
>
> (2) 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
>
> (3) To engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity.
>
> (b) Nothing in this section shall be construed to create a private right of action.[10]

As summarized by FERC, the elements needed for prosecution under Order No. 670 are as follows:

> (1) [u]ses 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 or that would operate as a fraud or deceit upon any entity; (2) with the requisite scienter; (3) in connection with the purchase of sale of natural gas or electric energy or transportation of natural gas or transmission of electric energy subject to the jurisdiction of the Commission.[11]

[10] 18 C.F.R. § 1c.1 (2006).

[11] FERC, Prohibition of Energy Market Manipulation, 71 Fed. Reg. 4244, 4253 (Jan. 26, 2006).

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The CFTC and the FERC have entered into an agreement to work cooperatively on information sharing.[12] The CFTC, however, is not necessarily guided by applicable securities law precedent in its energy market manipulation enforcement efforts.[13]

III. FEDERAL TRADE COMMISSION

The Federal Trade Commission was granted specific authority under Section 811 of the Energy Independence and Security Act of 2007 ("EISA") to impose civil penalties for market manipulation. The key provision, "Prohibition on Market Manipulation," states:

> 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 prescribe as necessary or appropriate in the public interest or for the protection of United States citizens.[14]

The language of this new statute is borrowed from the FERC authority, the Energy Policy Act of 2005, which is, as explained previously, borrowed from Section 10(b) of the Securities Exchange Act of 1934, making it unlawful for any person, "directly or indirectly … to use or employ, in connection with the purchase or sale of any security … any manipulative or deceptive device or contrivance…."

[12] Federal Energy Regulatory Commission, Memorandum of Understanding between the Federal Energy Regulatory Commission and the Commodity Futures Trading Commission Regarding Information Sharing and Treatment of Proprietary Trading and Other Information (Oct. 12, 2005), *available at* http://www.ferc.gov/EventCalendar/Files/20051020121515-MOU.pdf.

[13] *See* Commissioner Bart Chilton, A Better Understanding: Current Issues with SEC; Exempt Commercial Market Regulation, Remarks before the Futures Industry Association Expo Conference Washington Regulators' Panel, Chicago, Illinois (Nov. 29, 2007), *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opachilton-5.pdf (advocating increased coordination and communication between the CFTC and the SEC and commenting on recent U.S. Department of Treasury efforts to reform domestic financial market oversight by the proposed merger of the SEC and CFTC).

[14] Energy Independence and Security Act of 2007, Public Law 110-140, at § 811.

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Under the EISA, the FTC may prescribe "rules and regulations" that it believes are "necessary or appropriate in the public interest or for the protection of United States citizens." The FTC is currently in the rulemaking process under this statute, and its new rules are expected to provide additional guidance.

Section 811 is more limited than the FERC and CFTC statutory counterparts. The FTC is given only civil penalty authority against "any supplier" that violates § 811 for "not more than $1,000,000."[15] No criminal penalties are mentioned. These new civil penalties are imposed through the same process as are penalties under the Federal Trade Commission Act, which means that matters will be brought initially before an administrative law judge.

Moreover, the FTC is limited to "crude oil gasoline or petroleum distillates at wholesale." The language of this statute is somewhat confusing, apart from fact that commas were omitted. The language by itself could be limited to wholesale transactions, although there may be a textual argument that wholesale only modifies petroleum distillates. The term "distillates" should also cover only refined products like diesel fuel and fuel oil. However, it is unclear if petroleum distillation processes might even include natural gas liquids.

Another key question arises over the possible creation of a private right of action. The Energy Policy Act of 2005 expressly stated that the new FERC authority created no private right of action. However, there is no similar language in the EISA. This becomes problematic if the language of the FTC authority is interpreted in light of the Securities

[15] *Id.* at § 814.

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Exchange Act of 1934. Of course, under the Exchange Act, there is an implied private right of action, which has resulted in litigation under Rule 10b-5.[16] Thus, if FTC authority is to be interpreted similarly to FERC authority, which is based on the 1934 Exchange Act, then one might argue that the statute should also create an implied private right of action, which Congress did not specifically prohibit in the EISA.

The EISA, unlike the EPA, also has an antitrust savings clause, which states, "Nothing in this subtitle shall be construed to modify, impair, or supersede the operation of any of the antitrust laws."[17] Congress also tried to bar any preemption defense for state law claims. Section 815(c) provides that "[n]othing in this subtitle preempts any State law." In short, it appears that Congress allowed all antitrust laws and state laws to be enforced simultaneously with this new law, as well as allowing prosecution by CFTC and FTC for what may be essentially the same conduct.

IV. CONCLUSION

All three agencies will now play a role in policing market manipulation in energy. Obviously, the new effort by Congress to grant the FTC market manipulation prosecution power, which is based essentially on a securities-fraud model, opens a broad new front of regulatory action. The fraud approach being used by FERC and now by the FTC is not linked to traditional market power analysis under the antitrust laws. Moreover, there is little, if any, public guidance on how the agencies will divide their jurisdictional authority to avoid conflicts.

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[16] *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 128 S.Ct. 761 (2008); Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[17] Energy Independence and Security Act of 2007, Public Law 110-140, at § 815(b).

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