

June 20, 2008

Federal Trade Commission  
Office of the Secretary  
The Honorable Donald S. Clark  
Room 159-H  
600 Pennsylvania Avenue, N.W.  
Washington, DC 20580

**Re: Market Manipulation Rulemaking, P082900**

Dear Secretary Clark:

The Canadian Association of Petroleum Producers (CAPP)<sup>1</sup> is grateful for the opportunity to submit its comments on the Commission's Advanced Notice of Proposed Rulemaking (ANPR) in the referenced matter. The Commission has requested comment on the manner in which it should interpret and enforce the provisions under the Energy Independence and Security Act of 2007 (EISA), related to the prevention of market manipulation in the petroleum industry.

**Summary of CAPP's Interest and Position**

Canada is the largest foreign supplier of crude oil to the United States, accounting for approximately 18 percent of the total crude oil refined in the U.S. in 2007. Members of CAPP account for the production of essentially all of the crude oil supplies originating in Canada. CAPP projects that Western Canadian crude oil production will continue to increase, growing from 2.4 million barrels per day in 2007 to about 4.5 million barrels per day in 2020. Depending on the comparative economics that prevail from time to time, much of that additional production is expected to be exported to the U.S., at a point when the U.S. economy is increasingly in need of incremental supplies. Crude oil in North America trades freely in a deregulated, open, competitive market and CAPP fully supports the continued operation of these market forces.

The issues raised in the ANPR are important to the continued health and vitality of the cross-border trade in crude oil and other petroleum products between Canada and the U.S. CAPP recognizes that fraud and manipulation pose a potential threat to the successful and efficient functioning of petroleum markets in North America. In formulating rules to implement the Congressional directives, it is equally important that the market be allowed to function, and that artificial impediments do not curtail the impetus toward additional crude imports from Canada or the successful and efficient functioning of petroleum markets.

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<sup>1</sup> CAPP is a trade association incorporated pursuant to the laws of Alberta, Canada. It represents approximately 140 companies engaged in the production of oil, natural gas and other petroleum products. Its principal offices are located in Calgary, Alberta.

Given the preliminary nature of the Notice, CAPP will limit its comments to certain of the particular questions addressed to commenters. CAPP will also leave comments on any of the specific questions regarding US statutory and regulatory regimes and legal precedents to other commenters that have greater familiarity with those areas. At such time as specific rules are proposed CAPP may furnish further recommendations on those issues.

## **Comments**

### **A. General Comments Regarding Market Manipulation**

While market manipulation can adversely affect any commodity market, there appears to be little empirical evidence of any such behavior – nor of any adverse effects on crude oil markets – under the regime of unregulated pricing that has prevailed in the North American crude oil and petroleum-products markets over the past two decades. Trading in crude oil is long-established and highly liquid, and the volume and transparency of those transactions has worked to the benefit of all market participants. In the absence of a pattern of any particular market-distorting behavior or specific, recognized incidents of market manipulation, there is little empirical guidance as to what specific form regulatory prohibitions should assume in seeking to deter or combat manipulation in the marketplace.

Recently, the Commodities Futures Trading Commission (CFTC) has disclosed that it is conducting an investigation into crude oil trading and potential irregularities in markets. Other published accounts suggest that the established patterns of trading may be subject to volatility due to the emergence of new forms of speculative trading. The results of the CFTC investigation could prove to be instructive in delineating both the scope and nature of problems, if any, in the marketplace. To date, however, the track record is very sparse on the subject of whether or how manipulation is or may be occurring.

In this key respect the context of the statutory measures adopted in Section 811 of the EISA differs from that of the antecedent regulatory statutes that are noted in the ANPR. Notably, the prohibition of deceptive and manipulative acts that was brought about by the Securities and Exchange Act (SEA) and related Depression-era measures were aimed at well-understood and well-documented abuses of securities markets in that era: See *Stock Exchange Practices, Report on Committee on Banking & Currency*, S. Rep. No. 1455, 73d Cong. 2d Sess. (1934). (cataloguing commonly-employed schemes and abuses including “bear raids” “bucket shops,” and “stock watering.”)

As this history indicates, the SEC’s prohibitions of manipulation were adopted against the background of well-documented and indeed notorious abuses of securities markets. Reflection on these different circumstances suggests that the broad aim of the original SEC enabling legislation stands on a different footing from the EISA, in which Congress appears to have acted in anticipation of abuses rather than in response to them. Absent any such background, the rules being adopted to combat manipulation of crude oil

trading are more prophylactic than curative. As such, the Commission should afford all market participants with clarity and certainty regarding the scope and definition of prohibited activity in the sale of petroleum products, including crude oil.

Illustratively, disclosure was considered an essential element of the Securities Act of 1933, a remedy for the kinds of abuses that had undermined the economy and led to the market crash and depression. There is nothing comparable here to suggest that crude markets are being subjected to manipulation via disinformation or deception.

## **B. Defining Market Manipulation**

The definition proposed by the Commission seems appropriate as it reflects the language contained in the EISA. The addition of a requirement that an effect on price is a necessary element also reflects the intent of the EISA to prevent the manipulation of petroleum markets, which will manifest itself through an effect on prices. However, of greater importance here is the manner in which manipulative or deceptive device or contrivance is interpreted or defined, and whether any rules proposed are actually necessary or appropriate in the public interest or for the protection of United States citizens. These two issues should be carefully considered before any rules are made.

## **C. Effect on the Market**

CAPP believes that the focus of any rulemaking should be on practices that intentionally, willfully, or recklessly cause distortions in the market, and not on any behaviors that are reactions to market forces. The intent of the legislation and the rulemaking process is to prevent manipulation of markets where it is in the public interest to do so or required for the protection of United States citizens.

## **D. Scier/State of Mind; Penalties**

CAPP agrees that intent or state of mind should be made an essential element of prohibited conduct. In conjunction with explicit rules describing the substantive content of prohibited conduct, such a requirement is essential to carrying out the apparent Congressional intent and purpose of the new statutory proscriptions, without unduly impinging on the routine workings of the marketplace. Although the SEA standard, also accepted by the FERC, is quite high (intentional, willful or reckless conduct designed to deceive or defraud by controlling or artificially affecting market prices or market activity), CAPP prefers the standard set out in the Commodity Exchange Act (CEA) (a specific intent to injure a market through the execution of an intentionally manipulative strategy). The reason for this is that the potential penalties for violating a rule or regulation is quite high, and therefore unless the standard of intent is also very high, and the standards of conduct very clear, there could be a chilling effect on normal, legitimate market behavior.

In this context, the proposed rules implementing Section 811 should be specific, not general. They should afford clarity and certainty, not ambiguity and misgivings as to

the scope of prohibited transactions. Intent should be an integral element of prohibited conduct. Such an approach is vital to ensure that the markets are not diluted by the reluctance of participants to maintain their roles as sellers and buyers.

#### **E. The “In Connection With” Standard**

Section 811, Subtitle B prohibits fraud and market manipulation “in connection with the purchase or sale of crude oil...” At page 26 of the Notice, the Commission addresses the “in connection with” component of the prohibition, and notes that retail sales are excluded. Rather, the Congressional focus is on transactions “starting at the point at which crude oil is sold by the producer or importer.” CAPP understands from this language that the mere act of importing crude oil falls outside the scope of the transactions encompassed by the “in connection with” standard. Rather, it is the point at which imported crude is sold within the U.S. that serves as the nexus for the statutory and regulatory interdiction. CAPP suggests that this interpretation and this intent be expressly set forth in the text of the proposed rules.

As well, CAPP agrees with the FERC interpretation of the SEA, which requires allegedly manipulative activity to have been intended to affect a transaction. It is not appropriate to review actions or behaviors in a vacuum, and without connecting an activity to a particular transaction, there will be no context for determining whether the activity was in fact manipulative.

#### **F. In the Public Interest or For the Protection Of United States Citizens**

In order to ensure that rules are made in order to prevent manipulative behavior that is necessary or appropriate in the public interest or for the protection of United States citizens, the Commission must set objective standards as to what these concepts are and how they will manifest themselves in reality. These concepts must be included in the rules because it is a requirement of the EISA that the rules and regulations are created with that purpose in mind.

#### **G. Potential Practices**

World crude oil prices have risen over the past year to record high levels, at least in nominal terms, and with the concomitant frustration of consumers its is understandable in such a climate for the government to want a well-functioning petroleum market that is free of any manipulation. As already noted, the response of Canadian crude oil producers to higher prices and strong demand has been to maximize production thereby increasing the supply of crude oil available to North American refiners. This response is what one would expect in a well-functioning market. It is important, therefore, that the Commission not impose any regulations, however well-intentioned, that may disrupt the ability of the market to continue to operate efficiently.

CAPP is concerned that many of the potential practices described by the Commission may be considered manipulative. Although CAPP recognizes that the list is

intended to encourage discussion, most of the practices described occur regularly in a normally functioning market, and suggesting that these practices could be manipulative and rules prohibiting them could be enacted would be very damaging to the petroleum industry.

For example, the suggestion that refiners publicly announcing any scheduled refinery downtime in order to prevent breakdowns or to change equipment would be a manipulation of the market by allowing competitors to collude inappropriately shows a lack of understanding of market dynamics and the reason such announcements are made by refineries. The benefit of this practice today far outweighs any potential costs and is, in fact, essential to maintain the orderly day to day operations of the market.

Refineries can accept diverse types and qualities of crude oil with some configured to refine particular crude oil slates. These varying crude types are transported on oil pipelines in batches. For example, the Enbridge Lakehead Pipeline system that delivers Western Canadian crude oil to U.S. Midwest refineries currently transports about fifty different types of crude and almost 1.8 million barrels per day of throughput. If a refinery experiences an unannounced shutdown for maintenance after a producer has nominated a particular batch of crude to be delivered to that refinery, there is suddenly a supply of crude that needs to find a new home. Another refinery able to use this particular type of feedstock may not be found, so that parties will be left struggling to find a way to get this crude out of the pipeline so that it does not prevent the timely delivery of upstream crude batches from occurring. If the crude oil pipeline is already running close to capacity, as the of Enbridge Lakehead system is today, having crude batches sitting in breakout tankage for long periods of time will impact the efficiency of operations. Negative impacts would include increased transit times on the system, possible contamination among different crude types, potential pipeline apportionment and the shut-in of crude oil production.

Crude oil pipelines announcing that they may be approaching the limit of their transportation capacity is another important current market practice. This is a vital piece of information to crude oil producers that should not be withheld from the marketplace as contemplated in the ANPR. Producers will always want to avoid shut-in of production and the associated negative impacts on cash flows that are needed to sustain such a capital intensive and increasingly high cost industry. The knowledge that a pipeline may soon be in apportionment (i.e. unable to accommodate all anticipated nominations) will enable market participants to take actions to avoid supply disruptions. For example, producers can begin to investigate alternative transportation options that may be available to them. Also producers may co-operate by agreeing to comingle crude types on a pipeline thus reducing the strain on system tankage, thereby alleviating transportation constraints.

As discussed above, the current circumstances suggest that it may be prevailing commodity prices that have generated Congressional concern, rather than any identified abuses of trading rules or practices that have had specified effects on those markets. Under these circumstances, it is even more important that the rules not deter conduct that

is affirmatively beneficial to the workings of the markets. Rules that are overly broad or unduly vague can have the unintended consequence of reducing liquidity and discouraging participation in market transactions. These conditions, in turn, could result in reduced efficiency in the market, dampening of supplies, and significantly higher prices, precisely the opposite of the objectives Congress sought to achieve.

## **H. Conclusion**

In order to ensure that rules made to prevent manipulative behavior are in fact necessary or appropriate in the public interest or for the protection United States citizens, the Commission must set objective standards as to how these rules will manifest themselves in reality. The focus of any rulemaking should be on practices that intentionally, willfully, or recklessly cause distortions in the market, and not on any behaviors that are reactions to market forces. In defining specific conduct as manipulative or deceptive, the Commission should ensure that it does not encompass routine commercial practices.

Since domestic oil prices were deregulated more than 25 years ago, decisions as to pricing, production levels, and related commercial arrangements have been the responsibility of market participants. The trading practices and risk-management tools that have developed have been largely successful in serving an ever-burgeoning demand for petroleum products. Thus it is essential that the Commission not harm U.S. consumers by implementing rules that could disrupt the ability of the petroleum market to operate efficiently.

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