Before the
**FEDERAL TRADE COMMISSION**
Washington, D.C.

| | | |
|---|---|---|
| In the Matter of | ) | |
| | ) | |
| Market Manipulation Rulemaking | ) | Project No. PO82900 |
| | ) | |

**COMMENT OF**


**TIMOTHY J. MURIS**
**FOUNDATION PROFESSOR**
**GEORGE MASON UNIVERSITY SCHOOL OF LAW**

**AND**

**J. HOWARD BEALES, III**
**ASSOCIATE PROFESSOR, STRATEGIC MANAGEMENT AND PUBLIC POLICY**
**GEORGE WASHINGTON UNIVERSITY SCHOOL OF BUSINESS**


Filed: July 7, 2008

## INTRODUCTION[1]

Congress has authorized the Commission, at its discretion, to undertake the difficult and challenging task of regulating "manipulation" in wholesale markets for petroleum products. These markets are well functioning, highly competitive, and crucial to the operation of our economy. Congress placed this authority within the Commission's unfair and deceptive practices jurisdiction without providing precise guidance on the contours of any rule, but well aware of how the Commission exercises that jurisdiction. The Commission's long-standing approach, in both its consumer protection and competition missions, is to preserve and facilitate the competitive market *process*, not to dictate any particular market *outcome*.

Congress did use language – "manipulative or deceptive device or contrivance" – that, based on the common sense meaning of the words and their use in other statutory provisions, is aimed at preventing fraud and deception, a task with which the Commission is intimately familiar. Moreover, both the statutory language and the legislative history point to the SEC, FERC, and CFTC as relevant regulatory models, all of which require proof of scienter. Accordingly, any manipulation rule promulgated by the Commission should likewise address intentional acts of fraud and deception.

The potential costs of regulatory errors in administering a manipulation rule are substantial, and the Commission should focus on minimizing those costs. Whatever the precise contours of a rule, any definition should include defining manipulation as an act that is deceptive, that causes an effect on market prices, and is intended by the actor to have such a result. Because defining with specificity every potential deceptive practice that might manipulate wholesale markets is virtually impossible, any manipulation rule will of necessity be more general. This generality increases the risk of honest mistakes. Coupled with the extraordinarily high penalties, this uncertainty creates the risk of chilling legitimate business decisions. To avoid this result, any rule should, as stated above, require specific intent.

Finally, the Commission should follow its own clear precedents regarding when a failure to disclose is deceptive, and avoid importing broad disclosure requirements from highly regulated markets that simply have no place in wholesale petroleum markets. Excessive disclosure requirements would eliminate the incentive of firms to invest in the production of valuable information about future market conditions. Thus, the Commission should preserve its distinction between deceptive omissions and pure omissions, with the latter outside the scope of a manipulation rule.

---

[1] This comment reflects the authors' independent views on how the FTC could promulgate a manipulation rule, if it decides to do so, consistent with the market-based approach it takes in its antitrust and consumer protection missions. The authors have consulted with members of industry, including ExxonMobil.

## I. BY FOCUSING ON PROBLEMS IN THE MARKET PROCESS, THE FTC'S ENFORCEMENT REINFORCES, NOT SUPPLANTS, MARKETS

The FTC currently engages in market-oriented protection of the competitive process. The FTC's role is founded on the principle that the first line of consumer protection is vibrant competition in a strong, working market. In pursuing this agenda, the Commission, through aggressive enforcement and focused advocacy, strives to promote competition and encourage the unfettered exchange of accurate, non-deceptive information.

The agency does not attempt to function as a central planner that determines the appropriate or reasonable prices in given markets, but rather seeks to reinforce and protect the benefits of the market system. As a nation, we derive vast economic benefits from competition. These benefits cannot be taken for granted. The benefits, and the competition that yields them, are not immutable. The FTC has a special responsibility to speak for the competitive process and resist measures that would dissipate the benefits of competition by reducing the role of business rivalry in the economy. It has been the policy of the Commission not to second-guess the results of the competitive process, but only to act in those cases in which that process has been interfered with or corrupted.

This section first discusses how the FTC implements that policy in antitrust, and then turns to consumer protection. It addresses the Commission's role in protecting the market process from unfair and deceptive practices. Because Congress chose to define a rule violation as an unfair or deceptive act or practice, we discuss that part of the Commission's jurisdiction in more depth.

### A. Unfair Methods of Competition

The FTC and antitrust courts focus on activities that harm the competitive *process* and on any manipulative and exclusionary tactics of monopolists. Antitrust is not a command and control regulatory system. Courts eschew the exercise of attempting to determine whether prices in a market exceed the "competitive" price.[2] At the core of antitrust is the proscription on naked cartel behavior. The act of price fixing itself is the problem; antitrust preserves the *process* of a competitive marketplace. Reasonableness is *never* a defense to a charge of price fixing, a position the courts have held consistently.

The FTC and antitrust courts also proscribe certain behavior by single firms. Again, the focus is on the competitive *process*, not on the price charged or profit earned. Section 2 of the Sherman Act forbids certain monopolizing acts; it is not an offense to be a monopolist. As the Supreme Court recently stated in *Trinko*:

> The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. .... To safeguard the incentive to innovate, the possession of

[2] 3 Philip E. Areeda & Herbert Hovenkamp, ANTITRUST LAW §502, at 114 (2007).

monopoly power will not be found unlawful unless it is accompanied by an element of anticompetitive conduct.[3]

### B. Unfair or Deceptive Acts or Practices

Like regulations and policies aimed at unfair methods of competition, the primary goal of consumer protection policy has been to preserve and facilitate the competitive market *process*. As the Supreme Court said in one of the early FTC consumer protection cases, "The consumer is prejudiced if upon giving an order for one thing, he is supplied with something else. In such matters, the public is entitled to get what it chooses, though the choice may be dictated by caprice or by fashion or perhaps by ignorance."[4] Thus, the goal of consumer protection enforcement is to respect consumer preferences and to enable consumers to satisfy those preferences. Second-guessing what consumers should have wanted, or whether their choices were good for them, would substitute the Commission's choices for those of consumers, and lead to a less efficient market outcome.

#### 1. Deception.

Most of the Commission's consumer protection actions involve charges of deception. A representation, omission, or practice is deceptive if it is likely to mislead consumers, acting reasonably in the circumstances, about a material fact.[5] As the Commission noted in *International Harvester*, "deception jurisdiction acts to safeguard the exercise of consumer sovereignty."[6] The Commission called deception "a particularly troublesome form of conduct," that is "harmful to consumers, undermines the rational functioning of the marketplace, and ... never offers increased efficiency or other countervailing benefits."[7]

The goal of policing the market to prevent deception is to preserve the market process. With accurate information, consumers are free to make their own choices; deception distorts the information available to consumers. Materiality requires that different (and accurate) information would likely influence consumer choices, thereby limiting the Commission's attention to information that is likely to matter in the market. But it does not empower the Commission to second-guess consumer decisions. As the Deception Policy Statement notes, "In evaluating materiality, the Commission takes consumer preferences as given."[8]

---

[3] *Verizon Communications v. Law Offices of Curtis V. Trinko*, 540 U.S. 398, 407 (2004).

[4] *FTC v. Algoma Lumber*, 261 U.S. 67, 78 (1934) (internal citations omitted).

[5] Letter from the Federal Trade Commission to Hon. John D. Dingell, Committee on Energy and Commerce(Oct. 14, 1983) ("FTC Policy Statement on Deception"), *available at* http://www.ftc.gov/bcp/policystmt/ad-decept.htm.

[6] *In re International Harvester Co.*, 104 F.T.C. 949, 1055-56 (1984). The Commission also noted that "the touchstone here is free consumer choice. We do not look for evidence that the product selected is actually inferior to its alternatives." *Id.* at n. 16.

[7] *Id.* at 1056.

[8] FTC Policy Statement on Deception, at n. 46.

Fighting fraud is at the heart of the Commission's efforts to combat deception. Fraud is perhaps the most fundamental frustration of consumers' choices. A seller promises a product or service with specified characteristics, and then either does not deliver at all or delivers goods of substantially lower value. Fraud is essentially theft. Like price fixing, it distorts the competitive process and limits the ability of consumers to make informed choices.

Because accurate information in the hands of consumers is essential if their choices are to direct markets, an important goal of consumer protection policy is to preserve both the flow of information and the integrity of the information provided in the competitive process. Most sellers are not fraudulent, but the Commission scrutinizes misleading and deceptive claims in contexts other than fraud. The Commission has long been vigorous in pursuing deceptive claims in advertising to assure that consumers are receiving what they were promised. Truthful advertising is an important force in competitive markets that can lower prices, encourage innovation that improves product quality, and help match consumers with the products that best suit their preferences.[9]

The Commission has long recognized these benefits. It issued a policy statement addressing private restrictions on comparative advertising;[10] it has pursued cases and rules against both governmental and private entities that have sought to restrict truthful advertising;[11] and it has encouraged other government agencies to remove restrictions that impede the flow of accurate, material information.[12] These policies help to reinforce consumer choices as the guiding force in competitive markets.

The Commission also has pursued cases involving inadequate disclosure, to assure that consumers know what they will have to pay for a product or service. But it has recognized that requiring too much information can be the equivalent of a prohibition, and frustrate the ability of sellers to advertise attributes that are important to consumers.[13] Similarly, it has sought to protect consumers who misunderstand a communication, but it also has recognized that advertising is necessarily imperfect and that some consumers will always misunderstand. Rather than seek the impossible, the Commission insists that consumer interpretations must be reasonable before they are actionable.

---

[9] *See* Timothy J. Muris & J. Howard Beales, STATE AND FEDERAL REGULATION OF NATIONAL ADVERTISING 7-10 (1993) (reviewing the impact of advertising on competition).

[10] FTC Policy Statement in Regard to Comparative Advertising, 16 C.F.R. § 14.15(b) (2003); *see also* R. Pitofsky, *Beyond Nader: Consumer Protection and the Regulation of Advertising*, 90 Harv. L. Rev. 661, 671 (1977) (discussing the advantages to consumers and competition that flow from comparative advertising).

[11] *See American Med. Ass'n*, 94 F.T.C. 701 (1979); Advertising of Ophthalmic Goods and Services, Statement of Basis and Purpose, 43 Fed. Reg. 23992 (June 2, 1978) (promulgating 16 CFR Part 456).

[12] *See, e.g.*, Letter from Staff of the Federal Trade Commission to the Clerk of the Alabama Supreme Court (Sept. 30, 2002), *available at* http://www.ftc.gov/be/V070001.pdf; Submission of the Staff of the Federal Trade Commission to the American Bar Association Commission on Attorney Advertising, Wash., D.C. (June 24, 1994); Comments of FTC Staff to the FDA on Nutrient Content Claims (July 27, 2004), *available at* http://www.ftc.gov/be/V040020.pdf.

[13] For example, it streamlined the disclosure requirements for warranty advertising incorporated in the Guides for the Advertising of Warranties and Guarantees, 16 C.F.R. 239.

### 2. Unfairness.

The second prong of the Commission's consumer protection legal standard is the prohibition on "unfair" acts or practices. A practice is unfair if it causes substantial consumer injury, without offsetting benefits to consumers or competition, that consumers cannot reasonably avoid.[14] Unfairness is a more general concept than deception, broader in its potential applicability, and subject to standards for its use that are correspondingly more stringent. As the Commission noted in International Harvester, "... unfairness is the set of general principles of which deception is a particularly well-established and streamlined subset."[15] Whenever it is used, the Commission's "unfairness" authority requires careful attention to the benefits and costs that a practice creates for consumers.

The primary purpose of the Commission's modern unfairness authority continues to be to protect consumer sovereignty by attacking practices that impede consumers' ability to make informed choices. Unfairness does not allow the Commission to substitute its judgments for those of the marketplace. Rather, "the principal focus of our unfairness policy is on the maintenance of consumer choice or consumer sovereignty, an economic concept that permits specific identification of conduct harmful to that objective."[16] Thus, like unfair methods of competition, unfair acts or practices highlight defects in the market's competitive *process*.

Although unfairness is an important, if infrequently used, element of the Commission's consumer protection arsenal, it would appear to have no place in establishing or implementing a manipulation rule. The statutory language and other regulatory models focus on specific "manipulative and deceptive" practices, not the precise balancing of costs and benefits that unfairness contemplates.

## C. Following The FTC's Basic Mandate, Any Manipulation Rule Should Focus on Fraud and Deception

Fraudulent and deceptive conduct undermine the market's competitive process because they impair efficient price discovery, which is the process of incorporating information in the market price. If one market participant gives incorrect information to others, the market clearing price will reflect that false information, just as it would incorporate other information participants bring to the market. The result, however, will not be the price that best reflects all available information. Unless we know the unknowable – i.e., the "true" price – there is nothing about the resulting price that would tell us it is wrong. It is only by examining the market process, and learning that the price was based in part on deception, that we can conclude it is the "wrong" price.

Congress was well aware of the FTC's longstanding approach to protecting the market process, its expertise in this task, and its enforcement strategy that avoids second-guessing

---

[14] 15 U.S.C. § 45(n).

[15] *In re International Harvester Co.,* 104 F.T.C. at 1060.

[16] *Id.* at note 47.

market outcomes. Presumably it gave the FTC, rather than some other agency, the authority to address manipulation in wholesale oil markets because it wanted the Commission to use its unique expertise in protecting the market process in developing a rule. When Congress gave FERC authority to address manipulation, it also provided direction about what FERC's rule should contain. It did not do so with the FTC.

Congress also specified that the Commission's rule should define violations as unfair or deceptive acts or practices. Again, it presumably did so for a reason – it wanted the rule to address the risks of unfair or deceptive practices in wholesale petroleum markets. Both the Commission's expertise in supporting the market process and Congress' placement of this authority within a consumer protection framework, argue strongly that any rule promulgated by the Commission should address fraud and deception, not market outcomes.

## II. ANY NEW RULE BY THE COMMISSION SHOULD REQUIRE AN INTENT TO MANIPULATE

Manipulation also raises issues that differ significantly from those the Commission has ordinarily confronted in its mission to protect the integrity of the market process. Nevertheless, the principles behind the Commission's well-established approaches to competition and consumer protection issues should inform any new manipulation rule.

The Commission has long recognized the need to devise regulatory and enforcement policies and approaches that minimize the risk of errors. In applying the advertising substantiation doctrine, for example, the Commission recognizes the need to consider both the benefits of mistakenly prohibiting truthful claims, and the costs of mistakenly allowing false ones.[17] However carefully crafted, any rule and its subsequent enforcement creates the risk of mistakes, through failure to regulate when necessary, or mistakenly regulating when doing so is counterproductive. In addressing market manipulation, the potential costs of mistakenly regulating are likely to be high because these are well-functioning, highly competitive markets crucial to the operation of our economy. Moreover, they are likely to be considerably higher than the costs of similar errors in addressing alleged manipulation of financial markets.

Of course, failure to intervene when intervention is necessary is also an error, and creates costs to consumers and competition. Nevertheless, wholesale petroleum markets are characterized by sophisticated, well informed buyers and sellers, who are well aware of the motivations of their counterparties. They are normally capable of protecting themselves from possible deceptive or manipulative practices, and generally do so as a matter of course. Moreover, the possibility of manipulation creates incentives to avoid the effects of the manipulation. Indeed, in the absence of regulation, the primary costs of manipulation are likely to be the costs that other parties incur to avoid its effects. Although manipulation creates real costs to consumers that are worth avoiding whenever possible, the costs of mistaken intervention based on overbroad regulation are likely significantly higher.

[17] FTC Policy Statement Regarding Advertising Substantiation, appended to *In re Thompson Medical Co.*, 104 F.T.C. 648, 839 (1984), *aff'd*, 791 F.2d 189 (D.C. Cir. 1986), *cert. denied*, 479 U.S. 1086 (1987), *available at* http://www.ftc.gov/bcp/guides/ad3subst.htm.

## A. The Costs of Regulatory Errors in Administering An FTC Manipulation Rule Could be High

In the ordinary course of business, participants in wholesale oil markets engage in numerous transactions that could be subject to second-guessing arguably as "manipulation." Depending upon how competitors respond, decisions about how to distribute and sell inventories across geographic markets could influence prices, raising price in some markets and reducing it in others, compared to some alternative decisions on sales and distribution. Decisions to hold (or release) inventory could influence prices over time, raising (lowering) prices today but likely reducing (increasing) future prices. Indeed, *any* transaction involves decisions about both the timing and the geographic sale and distribution of products. A sale of product at a particular price is a decision to sell today rather than later, in this market or to this buyer rather than some other. Moreover, the fact that both supply and demand are extremely inelastic in the short run means that the price effects of such decisions may often be significant. Judgments about the "right" mix of sales and distribution are beyond the capacity of any individual or organization to make accurately. That, of course, is why our economy relies on markets to make such decisions, and on the profit motive to guide the behavior of individual firms. Second-guessing those outcomes would risk serious disruptions of a well-functioning competitive market.

Any new manipulation rule will apply to markets that trade physical commodities. The vast majority of futures market transactions are settled by offsetting transactions in the futures market itself. Thus, a trader who has sold a contract to deliver oil in December typically settles that obligation by buying back the contract. Apart from the relatively few transactions settled through actual delivery, such transactions can lock in the price, but they do not affect the actual ownership of the commodity.

The costs of mistaken intervention in wholesale oil markets are likely to be greater than the costs of errors in the financial markets from which concepts of market manipulation have emerged. Although financial markets influence physical markets, random errors in applying the rules that keep some potential participants from trading in financial markets will reduce the volume of trade, and therefore reduce market liquidity. The primary effect of that error is to increase the variability of prices.[18] Unless application of the rule creates systematic errors that prevent a whole class of potential traders from participating or otherwise impairs the linkage between financial and physical markets, the rule is unlikely to affect the overall level of prices.[19]

[18] Organized markets facilitate price discovery through standardizing contract terms and reducing counterparty risk by making the exchange the counterparty in every transaction. These features enhance liquidity and increase the volume of trade that occurs. In turn, increased trading volume enhances the price discovery process, because higher volume with more market participants will reduce the variability of the market clearing price. *See* Lester Telser, *Why There Are Organized Futures Markets*, Journal of Law and Economics, April 1981.

[19] Even if the level of prices is influenced at a particular point in time by mistaken intervention in financial markets, the consequences are less significant than in markets for the commodities themselves. Futures markets are important, because they provide information that will influence future production and investment decisions. But the nature of such decisions is that they are based on price expectations over the long term, not the price of a contract that is about to expire. *See* Frank A. Easterbrook, *Monopoly, Manipulation, and the Regulation of Futures Markets*, 59 Journal of Business S103 (1986). The possibility of distorted prices is greatest in the last few days before

The situation is different when the trades at issue involve the ownership of physical commodities. What is at stake is control over the commodity, and ultimately the ability to consume it. Mistakes prevent goods from moving to where they are most highly valued, and therefore reduce welfare. Physical markets involve ownership and eventual consumption of the product. Because they affect who actually gets what, the consequences of mistaken governmental regulation are likely higher than the effect on price variability in paper markets.

Wholesale markets for refined product determine where gasoline and other distillates will go. Decisions about how much of which product to sell in which geographic market are made almost continuously as refined products flow through the market's distribution system. When errors occur in gasoline markets, for example, the result may be that that some areas have more gasoline than they need and others have shortages. Faced with an unanticipated supply disruption, there is not the same "need" for a contract for future delivery as there is for an immediate supply of gasoline or home heating oil to (potentially) millions of consumers.[20] Errors that result from the mistaken application of a manipulation rule to decisions related to the sale and distribution of gasoline or home heating oil will result in more serious costs to consumers.

The risk that decisions about particular transactions will be judged in hindsight to have been "manipulation" will inevitably encourage participants to make "safe" decisions that are easy to defend on the basis of past practice and established trading patterns. Particularly when disruptions occur due to uncontrollable events such as a hurricane or failure of a vital transportation facility, however, an effective market response will often require creative decisions. Choices that deviate from the normal pattern may be essential to alleviate the disruption as rapidly as possible.

### B. A Requirement For The Commission to Prove Intent is An Effective Way to Reduce The Risk of Errors

One way to reduce the risk of errors is to require a showing of (1) an effect on price,[21] (2) caused by a deceptive act, and (3) that the manipulator intended this result. Intent is a critical element of this approach. As noted above, numerous daily decisions could influence the market price. Thus, market participants cannot necessarily avoid liability by avoiding an effect on price. Instead, there must be some other way to conduct daily business without fear of second-guessing by regulators, either on their own or spurred by counter-parties or competitors.

---

*(Footnote Con't.)*

expiration of a particular contract, because the volume is lower and traders are under pressure to settle their obligations either by an offsetting transaction or by delivering (or accepting delivery of) the commodity itself.

[20] The value of a futures contract in this context is that it reveals the likely market clearing price at some future date, and allows traders to hedge the risk of price changes.

[21] The Commission is authorized only to prohibit manipulation, not attempted manipulation. By contrast, the Commission's precautionary approach to deception is motivated largely by the language and the preventive nature of the FTC Act. Thus, the Commission, need not distinguish between actual deception and attempted deception. A

Similarly, limiting "manipulation" to deceptive conduct, without more, is inadequate by itself to prevent avoidable regulatory errors. Although participants in wholesale markets can certainly avoid deliberate falsehoods or express misrepresentations of material facts, they cannot control what inferences other market participants might draw from statements that may be completely truthful based on the knowledge of the party that made the statement. Different market participants, however, have different information, and given a recipient's knowledge, the recipient may draw an inference that is both incorrect and not what the person who made the statement intended to convey.

Such a problem is familiar in marketing consumer goods, but it is reasonable to presume that marketers have expertise and the ability to gather more information about how consumers will interpret particular claims. Thus, strict liability even for implied claims is appropriate. By contrast, traders in wholesale markets may differ substantially in their information and expectations about the state of the market, and have little ability to gather additional information about the inferences other traders will draw.[22] Thus, even limiting the rule to deceptive claims provides inadequate protection for honest market participants who make honest mistakes.

For example, one key fact that will influence many decisions and the accuracy of many potential statements by market participants involves expectations about future prices. At any given time, some participants likely believe that future prices will rise, while others believe they will fall (or at least rise less). Ex post, it will be clear who was right. But second-guessing claims based on what actually happened is extremely hazardous to efficient market outcomes, because it will discourage decisions based on those expectations.[23] And second-guessing whether there was a "reasonable basis" for a particular set of expectations is every bit as difficult. The relevant information that reasonably influences expectations is changing constantly, and cannot be frozen in time for the Commission to examine easily in hindsight.

Deliberate false reports of transaction details to influence a price index should be a violation of a manipulation rule. But some "express" misrepresentations may be innocent. For example, firms that provide information for an index will seek to minimize their costs of doing

---

*(Footnote Con't.)*

manipulation rule that relies on the threat of substantial penalties would be punitive, rather than preventative. This distinction (and the requirement that there be *actual* manipulation) makes sense, given that consumers can be harmed by a deceptive scheme to manipulate a market only if that deception actually succeeds in altering the market price relative to what it would have been absent the deception. Moreover, the anti-manipulation provisions of section 811 do not displace other consumer protection statutes or the requirements of other agencies that proscribe various forms of manipulation or attempted manipulation.

[22] Even if one could imagine a "copy test" on the relevant audience of other traders, the usual assumption in a copy test is that consumers will give accurate responses to questions about the message the communication conveys. That assumption is dubious at best when the relevant audience is traders with a strong interest in the same transaction and the potential to gain or lose significant amounts based on their answers.

[23] To be sure, futures prices provide an unbiased estimate of price trends. But an unbiased estimate is not always right. Market-based estimates are attractive because, if they are wrong, they set in motion forces that will lead to their revision – but only if parties with contrary expectations can safely act on their beliefs.

so. If liability for potential manipulation reduces participation, it may make indices in thinly traded markets less reliable, not more.

The Commission has long familiarity with applying different standards of intent in circumstances in which the costs of mistakes differ. The consequences of mistakes are lowest when the Commission seeks only a prospective order restricting certain conduct. In such instances, the Commission need not show intent at all. Nonetheless, there is a potential for regulatory mistakes and a need for steps to minimize those risks to the extent possible. The Commission's "reasonable basis doctrine" explicitly recognizes that the amount of evidence required to substantiate the claim is lower when the consequences of mistakenly prohibiting truthful claims are higher.[24] Thus, the finding of liability expressly considers the costs of mistakes.

Although the Commission's civil fraud cases, including those in which it seeks equitable relief, do not generally require a showing of intent, fraud does not happen by accident, and such cases are usually quite straightforward, with little risk of mistake. Moreover, the nature of equitable remedies means that the relief ordered is tailored to the court's view of the underlying conduct. The Commission would be unlikely to obtain the drastic kinds of equitable remedies that it frequently achieves if it ever encountered an apparent case of fraud in which honest error were a plausible alternative hypothesis.

The costs of errors are highest when criminal prosecutions are involved. Although the Commission does not bring criminal cases, it has increasingly worked with the criminal authorities to pursue the truly bad actors who defraud consumers. To bring such cases, the Commission and its law enforcement partners must establish criminal intent.

When the Commission pursues civil penalties for violations of its rules, the consequences of errors are somewhat lower than in criminal prosecutions, albeit still significant. Because civil penalties are purely financial remedies, and levied against corporate entities, the costs of error are lower than the costs of mistakenly sending someone to jail. Nonetheless, because liability for penalties can chill potentially valuable conduct that does not in fact violate the rule, significant costs of errors remain. Penalties, as opposed to injunctive relief, are available only if the Commission can establish that the respondent has "actual knowledge or knowledge fairly implied on the basis of objective circumstances that such act is unfair or deceptive and is prohibited."

In any manipulation rule, the Commission should require specific intent, rather than relying solely on the knowledge standard in the FTC Act. Because defining the specific deceptions that might manipulate wholesale markets is virtually impossible, any manipulation rule will of necessity be more general. In contrast, other Section 18 rules must define the unfair or deceptive practice "with specificity." The greater generality increases the risk of honest

[24] FTC Policy Statement Regarding Advertising Substantiation, appended to *In re Thompson Medical Co.*, 104 F.T.C. 648, 839 (1984), *aff'd*, 791 F.2d 189 (D.C. Cir. 1986), *cert. denied*, 479 U.S. 1086 (1987), *available at* http://www.ftc.gov/bcp/guides/ad3subst.htm.

mistakes. A stronger intent standard will reduce the risk of prosecuting honest mistakes and reduce the costs of error.

## III. ANY NEW RULE SHOULD PROVIDE A NARROW SCOPE FOR ACTIONABLE "OMISSIONS"

To avoid adverse consequences, it is particularly important that the Commission identify with clarity omissions of information that would be actionable under the rule. An effective requirement for too much disclosure could wreak havoc in wholesale petroleum markets.

There are important commercial reasons for secrecy about numerous business decisions. Perhaps most obviously, traders can hardly profit if they disclose their trading strategies for all to see. Investment plans, production decisions, production constraints, and the like are all routinely, and appropriately, treated as sensitive commercial information not subject to public disclosure. Some might argue, however, that the failure to disclose such information constituted a material omission, and was therefore a violation of a rule against manipulation.

The Commission should avoid this result. A complex aspect of all markets is motivating the production of information. Market participants only will invest in information if they can realize a profit by doing so, and they cannot profit from information if they must share it widely.[25] Thus, secrecy is necessary to motivate the production of information, which in turn is reflected in the market price through the market behavior of individual participants. Overly broad disclosure requirements could easily distort this delicate balance and create competitive distortions. Rather than increasing information in the market, such requirements could reduce the amount of information available, because they risk reducing the incentives for market participants to invest in creating information in the first place. Information that is not produced cannot be disclosed; it also cannot be reflected in the market price.

The Commission has long recognized a distinction between omissions of material information that are deceptive, and "pure" omissions that are not actionable on a deception theory. An omission of material information is deceptive if the information is necessary to correct a misimpression that the message, in the absence of the disclosure, would otherwise convey. That is, the omission must be an omission of information that is material *in light of* the representations made. In the absence of representations that create the need for the information, the failure to disclose the information is not deceptive.

By contrast, pure omissions arise when a seller is silent "in circumstances that do not give any particular meaning to his silence."[26] The variety of information that might be considered material by some significant number of consumers is virtually limitless (ranging from the conditions under which a product was produced, to the working conditions of employees in other countries). Because it is not possible to disclose all information that might be of interest to particular consumers, a more nuanced screen to determine whether disclosure is necessary is

[25] *See* Posner, ECONOMIC ANALYSIS OF LAW 111 (7th ed. 2007).

[26] *In re International Harvester*, 104 F.T.C. at 1059.

required. The Commission's unfairness analysis provides that screen, and in *International Harvester*, the Commission held that pure omissions must be analyzed under an unfairness theory, not deception.[27]

The FTC should follow its own well-established precedents and preserve a distinction between deceptive omissions and pure omissions. Disclosure obligations should go no farther than necessary to correct deceptive impressions that statements might otherwise convey.[28] Any broader standard would risk grave damage to wholesale petroleum markets.

## CONCLUSION

Any new manipulation rule adopted by the Commission should follow the Commission's well-established approach to protecting the market process. The Commission can achieve this objective by limiting the rule to fraudulent and deceptive conduct. Recognizing the differences between wholesale petroleum markets and financial markets, and the importance of the well functioning, highly competitive markets that are crucial to the operation of our economy, the rule should take care to avoid the potentially enormous costs of mistaken overregulation. It should require an effect on price and evidence of specific intent to manipulate the price. It should follow the Commission's clear precedents regarding when a failure to disclose is deceptive, and avoid importing broad disclosure requirements from highly regulated markets that simply have no place in wholesale petroleum markets.

---

[27] *Id.*

[28] We understand that the SEC has interpreted "manipulative or deceptive devices" to bar insider trading as a form of deception. FERC, however, has not imposed insider trading rules, even though it was directed to follow SEC precedents. The concept of insider trading is simply not applicable to wholesale petroleum markets. The traditional theory of insider trading holds that a corporate insider violates a duty to corporate shareholders. The misappropriation theory covers people who are not corporate insiders who seek to profit by misappropriating sensitive information from those with whom they share some other close relationship. *See* Linda Chatman Thomsen, Director, Div. of Enforcement, U.S. Securities and Exchange Comm'n, Opening Remarks to the Securities Industry and Financial Markets Association Regulatory Symposium on Insider Trading, (May 19, 2008).

Neither theory is applicable to wholesale petroleum markets, because employees do not participate in such markets on their own account. Rather, they engage in trading to benefit their employer, based on information obtained from or on behalf of their employer. Trading to take advantage of their company's knowledge and information *is* their fiduciary duty; it is not a breach of that duty. Moreover, either theory of insider trading helps to allow owners of information to profit from their investment in generating the information. Imposing the same "disclose or refrain from trading" obligation on the corporate participants in wholesale markets who generate information would destroy its value entirely, and destroy any incentive to acquire that information in the first place. That would undermine the market process, not protect it.