

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

Prohibition of Energy Market Manipulation )

Docket No. RM06-3-000

**INITIAL COMMENTS OF  
THE NATURAL GAS SUPPLY ASSOCIATION**

Pursuant to the Notice of Proposed Rulemaking issued in the above-captioned docket on October 20, 2005,<sup>1</sup> the Natural Gas Supply Association (“NGSA”) submits its initial comments regarding the Federal Energy Regulatory Commission’s (“Commission”) implementation of the anti-manipulation provisions of new Section 4A of the Natural Gas Act.<sup>2</sup>

**I. COMMUNICATIONS AND CORRESPONDENCE**

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**II. EXECUTIVE SUMMARY<sup>3</sup>**

NGSA supports safeguarding the integrity of natural gas markets. Natural gas markets must be clear of fraudulent and deceptive practices. The proposed rule<sup>4</sup> is intended to implement

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<sup>1</sup> Notice of Proposed Rulemaking, Prohibition of Energy Market Manipulation, Docket No. RM06-3-000, 113 F.E.R.C. (CCH) ¶ 61,067 (Oct. 20, 2005), 70 Fed. Reg. 61930 (Oct. 27, 2005), as corrected Errata Notice (Nov. 9, 2005), 70 Fed. Reg. 69474 (Nov. 16, 2005) (“NOPR”).

<sup>2</sup> Energy Policy Act of 2005, Pub. L. No. 109-58, § 315, 119 Stat. 594 (2005) (“EPAAct 2005”).

<sup>3</sup> No statement of issues is being tendered in connection with these rulemaking comments. See 18 C.F.R. § 385.202 (2005) (“[p]leadings do not include comments on rulemakings....”); 18 C.F.R. § 385.203(a)(7) (requiring the filing of a separate Statement of Issues in connection with pleadings and tariff and rate filings); Final Rule, Order No. 663, Revision of Rules of Practice and Procedure Regarding Issue Identification, Docket No. RM05-33, 70 Fed. Reg. 55723, 55724 n.1 (Sept. 23, 2005) (noting that “Rule 202 specifically excludes comments on rulemakings or comments on offers of settlement from the definition of pleading.”).

<sup>4</sup> The NOPR also proposes to implement Section 1283 of the Energy Policy Act of 2005 by adopting proposed rule 18 C.F.R. § 47.1, which is substantially identical to proposed rule 18 C.F.R. § 159.1, but applies to the purchase or

the directive of Congress to preclude any such abusive practices.

The Commission has signaled clearly that its primary objective is to foster compliance with the statutory standards. At least four fundamental issues should be clarified to facilitate the development of effective compliance efforts by industry participants. First, the Commission should clarify that it does not intend to incorporate by reference disclosure obligations and insider trading restrictions applicable to issuers of securities into the context of bilateral energy commodities trading. Second, the Commission should confirm its intent to consider prevailing Securities and Exchange Commission (“SEC”) precedent with respect to the elements required to sustain a claim of market manipulation under Section 315 of the Energy Policy Act of 2005; namely, misrepresentation or omission of a material fact; scienter; causation; reliance; and, damages. Third, the Commission should indicate that it intends to follow established judicial doctrines on relevant settled issues (e.g., the nature of “recklessness” necessary to constitute scienter) and should clarify the applicable limitation period that will apply to enforcement of the new rules. Fourth, the Commission should clarify that the NOPR does not supersede or modify the Commission’s policy statement on price reporting and the related safe harbor created pursuant to that policy.

### **III. NGSA’S INITIAL COMMENTS**

Established in 1965, NGSA represents major integrated and large independent domestic producers of natural gas. NGSA’s mission is to ensure a competitive natural gas market that is supported by appropriate regulations. As part of this mission, NGSA seeks to maintain competitive markets, improve downstream efficiencies and to foster increased supplies of natural

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sale of electric energy or transmission services subject to the jurisdiction of the Commission. These comments address the NOPR as applied to natural gas sales and interstate transportation subject to the jurisdiction of the Commission, but the comments may be equally applicable to the Commission’s implementation of Section 1283 of the Energy Policy Act of 2005.

gas to markets throughout the United States.

In the Energy Policy Act of 2005, Congress granted the Commission authority to eliminate market manipulation in the natural gas industry through the use of manipulative or deceptive devices or contrivances.<sup>5</sup> Section 315 of the Energy Policy Act of 2005 provides:

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 10(b) of the Securities Exchange Act of 1934)... 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.<sup>6</sup>

While the new anti-manipulation provision of the Energy Policy Act of 2005 expands the Commission's authority to prevent market manipulation, nothing in the statute grants the Commission rate or certificate jurisdiction over deregulated first sales of natural gas in the United States. As Chairman Kelliher recently explained:

...[t]he Commission has limited jurisdiction over the price of natural gas. Through the Natural Gas Policy Act of 1978 and the Natural Gas Wellhead Decontrol Act of 1989, Congress deregulated most sales of natural gas, including imports from countries with which the United States has a free-trade agreement. The Commission's jurisdiction over wholesale sales is limited to sales of gas in interstate commerce by interstate pipelines, intrastate pipelines, local distribution companies (LDCs) and the affiliates of those entities (including marketers), so long as they do not produce the gas they sell.<sup>7</sup>

The NOPR proposes to implement Section 315 through the adoption of proposed rule 18 C.F.R. § 159.1:

- (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,

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<sup>5</sup> See 15 U.S.C. § 78j(b) (2005).

<sup>6</sup> EAct 2005 at Sec. 315. Section 318 of the Energy Policy Act of 2005 also authorizes the Commission to seek an order from a United States District Court to ban individuals who have violated Section 315 from engaging in the business of purchasing or selling natural gas or the purchasing or selling of transmission services subject to the jurisdiction of the Commission.

<sup>7</sup> Testimony of the Hon. Joseph T. Kelliher, Chairman, Federal Energy Regulatory Commission before the Subcommittee on Energy and Air Quality, Committee on Energy and Commerce, United States House of Representatives, at 5-6 (November 2, 2005).

- (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 person.

(b) Nothing in this § 159.1 shall be construed to create a private right of action.

The NOPR further explains that the proposed rule is virtually identical to SEC Rule 10b-5, noting that “[t]his approach should provide benefits to entities subject to the new rule because there is a substantial body of precedent applying the comparable language of Rule 10b-5.”<sup>8</sup>

*A. NGSAs Supports Initiatives to Safeguard the Integrity of Natural Gas Markets.*

Natural gas markets must be clear of fraudulent and deceptive practices. The proposed rule is intended to implement the directive of Congress to preclude those practices, based on the standards developed in connection with the administration of Section 10(b) of the Securities Exchange Act of 1934.

NGSA understands that the central objective of the NOPR is to foster compliance. Corporate compliance efforts can best be developed and implemented if clear guidelines can be provided to industry at the outset of the initiation of this new regulatory program.

While a substantial body of judicial and administrative precedent has been developed in connection with litigation involving Rule 10b-5, much of that litigation arises in a commercial context that is substantially different from the business of buying and selling natural gas or electric energy. A substantial portion of the precedent addressing Rule 10b-5 addresses sales of securities to the public at large—an activity in connection with which the availability of information about the securities sold is critical to investors seeking to evaluate the merits of the

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<sup>8</sup> NOPR at P 2.

potential investment. Energy trading activities, in contrast, generally involve bilateral contracts between experienced, knowledgeable market participants whose focus is typically not on information but on the commercial terms for the sale of a commodity.

In light of the fundamental differences between the sale securities and the sale of energy commodities, at least four fundamental issues with respect to implementation of the proposed regulations should be clarified to facilitate industry participants' effective compliance with the regulations. First, the Commission should clarify that it does not intend to incorporate by reference disclosure obligations and insider trading restrictions applicable to issuers of securities into the context of bilateral energy commodities trading. Second, the Commission should confirm its intent to consider prevailing judicial precedent with respect to the elements required to sustain a claim of market manipulation under Section 315 of the Energy Policy Act of 2005. Third, the Commission should indicate that it intends to follow established judicial doctrines on relevant settled issues involving Rule 10b-5 to the extent such doctrines are applicable to the energy commodity context (e.g., the nature of "recklessness" necessary to constitute scienter) and should clarify the applicable limitations period that will apply to enforcement of the new rules. Fourth, the Commission should clarify that the NOPR does not supersede or modify the Commission's policy statement on price reporting and the related safe harbor created pursuant to that policy.

*B. The Commission Should Clarify that the Disclosure Obligations Applicable to Issuers of Securities Fall Outside the Scope of the New Proposed Rule.*

In the context of private securities litigation, "[a] duty to disclose arises only when one party to a transaction has material information that the other party is entitled to have because of some relationship of trust and confidence between the parties, such as when one party is a

fiduciary, corporate insider or ‘tippee.’”<sup>9</sup> Through Regulation FD, the SEC also has imposed additional disclosure obligations on issuers of securities. Issuers generally may not make selective disclosures of material, non-public information to only a selected few (for example, large institutional investors).

Applying rules relating to mandatory disclosure applicable to issuers of securities would make little sense in the context of energy trading operations. Assume a gas trader developed information suggesting that anticipated weather conditions would cause prices to rise at a particular pricing point in a given month or a gas producer knew of substantial changes in production rates that were scheduled to occur. To avoid a claim of manipulation, would the trader be obligated to share his or her view of market fundamentals with all potential counterparties? Would the producer be required to reveal all knowledge of future production rates?<sup>10</sup> Nothing in the NOPR or the text of Section 315 of the Energy Policy Act of 2005 suggests that such sweeping mandatory disclosure requirements would, could, or should be applicable. As noted above, existing court precedent applicable to the duty to disclose indicates that no such obligation would attach, given the absence of “some relationship of trust or confidence between the parties, such as when one party is a fiduciary, corporate insider or ‘tippee.’” For avoidance of doubt, NGSA requests clarification

*C. The Commission Should Clarify The Core Elements of a Manipulation Claim Under the New Proposed Rule.*

Claims relating to alleged violations of Rule 10b-5 arise in two distinct contexts: private claims for relief and federal enforcement actions. Federal courts interpreting private claims brought pursuant to Rule 10b-5 require that five core elements be established to predicate a

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<sup>9</sup> *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 213 (3d Cir. 2001), *cert. denied*, 536 U.S. 923 (2002)(citation omitted). See also *Chiarella v. United States*, 445 U.S. 222, 230 (1980).

<sup>10</sup> Such disclosures would potentially present their own set of antitrust issues to the extent they could be construed as price or market signaling.

violation of the Rule:<sup>11</sup> “(1) a misrepresentation or omission of a material fact; (2) scienter; (3) causation; (4) reliance; and (5) damages.”<sup>12</sup>

For purposes of Rule 10b-5 a misrepresentation or omission generally is considered to be material if there is a substantial likelihood that a reasonable investor would have acted differently if the misrepresentation had not been made or the truth had been disclosed.<sup>13</sup>

The concept of “scienter” requires a showing of conscious misconduct or deliberate recklessness.<sup>14</sup> The concepts of causation, reliance and damages in the context of private securities litigation encompass the notion that an alleged manipulative act actually causes quantifiable harm in order to be actionable.<sup>15</sup>

*D. To Promote Certainty, the Commission Should Clarify That It Intends to Rely on Established Federal Court Precedent in Exercising its New Enforcement Authority.*

The NOPR correctly observes that federal courts have developed an extensive body of case law interpreting Rule 10b-5.<sup>16</sup> To promote certainty, NGSa requests that the Commission clarify that it intends to rely on established existing federal court precedent in the administration of its new enforcement authority to the extent such precedent has applicability in the context of the energy markets.

As an illustration, the NOPR observes<sup>17</sup> that in some circumstances, courts have held that recklessness satisfies the “scienter” or intent requirement of Rule 10b-5, a requirement that appears to be equally applicable in both private securities litigation and SEC enforcement

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<sup>11</sup> In connection with federal enforcement proceedings seeking injunctive relief or imposing restrictions on traders, different standards are applied. See, e.g., SEC v. Rana Research, Inc., 8 F.3d 1358, 1363-64 (9th Cir. 1993) (reliance not a necessary element of enforcement claim for injunctive relief); Graham v. SEC, 222 F.3d 994, 1001-03 (D.C. Cir. 2000) (damages need not be proven by SEC in connection with SEC trader enforcement proceeding).

<sup>12</sup> Livid Holdings Ltd. v. Salomon Smith Barney, Inc., 416 F.3d 940, 946 (9th Cir. 2005); see, e.g., Dura Pharms., Inc. v. Broudo, 125 S.Ct. 1627 (2005).

<sup>13</sup> Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); Livid Holdings, 416 F.3d at 946-47. See also Starr v. Georgeson Shareholder, Inc., 412 F.3d 103, 110 (2d Cir. 2005).

<sup>14</sup> Livid Holdings, 416 F.3d at 948.

<sup>15</sup> See, e.g., Dura Pharms., Inc., 125 S.Ct. at 1633-34.

<sup>16</sup> NOPR at P 12 (footnotes omitted).

<sup>17</sup> Id. at P 13 n.20.

actions.<sup>18</sup> In Sundstrand Corp. v. Sun Chem. Corp.<sup>19</sup> the Seventh Circuit defined “recklessness” as:

a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.<sup>20</sup>

The court stated that this “definition of recklessness is the kind of recklessness that is equivalent to willful fraud” and “should be viewed as the functional equivalent of intent.”<sup>21</sup> Other circuits have adopted virtually identical positions.<sup>22</sup>

The Commission should also clarify the applicable statute of limitations that will apply to enforcement of the new rules. To the extent that markets are constantly changing, it would be unproductive for the Commission to enforce stale or no longer relevant claims, and the time for enforcement should be limited to the same extent as are claims under the existing market behavior rules.

*E. The Commission Should Clarify That the NOPR Does Not Supersede or Amend The Commission’s Policy Statement of Natural Gas and Electric Price Indices and the “Safe Harbor” Established by That Policy.*

In its Policy Statement on Natural Gas and Electric Price Indices,<sup>23</sup> the Commission stated:

For data providers that can demonstrate that they have adopted and followed [the Commission’s policy statement regarding price reporting] ..., the Commission will

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<sup>18</sup> See, e.g., SEC v. George, 426 F.3d 786, 792 (6th Cir. 2005) (SEC may establish scienter through proof of recklessness, defined as “highly unreasonable conduct which is an extreme departure from the standards of ordinary care.”) (citing Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979)).

<sup>19</sup> 553 F.2d 1033, 1045 (7th Cir. 1977) (*en banc*).

<sup>20</sup> *Id.* citing Franke v. Midwestern Oklahoma Dev. Authority, 428 F.Supp. 719 (W.D. Okla. 1976), vacated on other grounds, 619 F.2d 856 (10th Cir. 1980).

<sup>21</sup> *Id.* (citations and internal quotations omitted).

<sup>22</sup> See, e.g., R2 Invs. LDC v. Phillips, 401 F.3d 638, 643 (5th Cir. 2005); Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, 395 F.3d 851, 854 (8th Cir. 2005); In re Alpharma Inc. Sec. Litig., 372 F.3d 137, 149 (3d Cir. 2004); Ponce v. SEC, 345 F.3d 722, 729 (9th Cir. 2003).

<sup>23</sup> Price Discovery in Natural Gas and Electric Markets, Docket Nos. PL03-3-000 *et al.*, 104 F.E.R.C. ¶ 61,121 at P 37, clarified, 105 F.E.R.C. ¶ 61,282 (2003), modified, 109 F.E.R.C. (CCH) ¶ 61,184 (2004), clarified, 112 F.E.R.C. (CCH) ¶ 61,040 (2005).

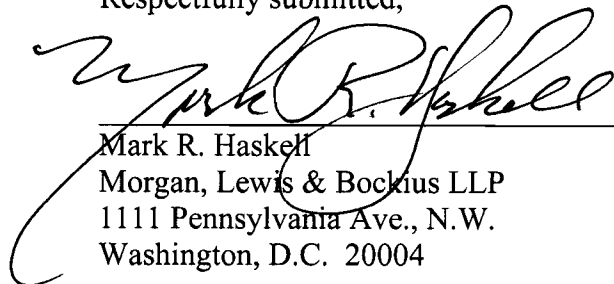
presume that transaction data submitted to index developers is accurate and timely and submitted in good faith. The Commission does not intend to prosecute and/or penalize parties for inadvertent errors in reporting, nor will it refer such issues to other agencies having jurisdiction. Companies adhering to those guidelines, including the error resolution processes, should be able to report all relevant trade data with confidence.

Nothing in the language of the NOPR proposes to modify or alter the Commission's policy statement on price reporting or the safe harbor rule adopted as an important component of that policy. In fact, the safe harbor rule is entirely consistent with the NOPR because both the NOPR and the safe harbor rule do not propose to penalize any person for inadvertent errors, as opposed to knowing and willful misconduct.

NGSA seeks clarification that the NOPR does not modify or supersede the Commission's policy statement on price reporting or the related safe harbor provision of that policy. Consequently, nothing in the NOPR mandates any changes to existing corporate compliance programs relating to price reporting.

WHEREFORE, for the foregoing reasons and to facilitate the prompt development of corporate compliance efforts, NGSA requests that the Commission grant the clarifications sought in these initial comments.

Respectfully submitted,



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Dated: November 17, 2005

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