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Wide-Ranging Oil Industry Investigation Unveiled

BY KENNETH M. BREEN, KEITH MILLER AND THOMAS R. FALLATI

In what it called an "extraordinary step," the Commodity Futures Trading Commission ("**CFTC**") recently disclosed a wide-ranging investigation into potential fraud, manipulation and abusive trading practices in the oil markets. The agency's far-reaching investigation, pending since December 2007, reaches all "practices surrounding the purchase, transportation, storage, and trading of crude oil and related derivative contracts." The agency also announced the formation of an interagency task force - including the Federal Reserve, the Department of the Treasury, the Securities and Exchange Commission ("**SEC**"), the Department of Energy and the Department of Agriculture - to study, among other things, "the role of speculators and index traders in the commodity markets."

The CFTC investigation comes amidst a historic spike in crude oil prices and intense congressional pressure to investigate whether market manipulation is to blame. Just this week, Representatives John Dingell and Bart Stupak questioned whether the agency has granted too many exemptions from reporting requirements and trading restrictions, and they demanded data for upcoming hearings on price manipulation. On the same day, the CFTC announced that it was amending its prior no-action letter to ICE Futures Europe to mandate the adoption of equivalent U.S. position limits and reporting requirements.

The CFTC's recent announcements are notable, because the agency has repeatedly disputed claims that the spike in oil prices is the result of market manipulation. It has pointed out that crude oil trading is still dominated by so-called "commercial" traders, such as oil companies and airlines, as opposed to "non-commercial" traders, such as institutional investors and hedge funds. The announcement of the investigation indicates that the agency is re-examining its position about manipulation in the oil markets.

The CFTC has cast a wide net to include both commercial and non-commercial traders. Among those whose conduct is being scrutinized, for instance, are index traders and swap dealers. They are currently classified as "commercial" traders, but critics have alleged that they in fact act as proprietary traders and may be involved in manipulation of prices. Non-commercial traders such as hedge funds have also received requests for information.

The CFTC's investigation appears to be focused on the traditional hallmarks of manipulative trading, including wash sales, matched orders, marking the close, market cornering or other manipulative forms of trading activity. To prove an attempted manipulation claim under the Commodity Exchange Act ("**CEA**"), the agency must prove intent to manipulate prices and an overt act in furtherance of the manipulation. Past cases provide a guide to the agency's approach to manipulation cases. In a case currently pending in federal court, the CFTC has alleged that the advisors to the Amaranth hedge funds "marked the close" by selling extraordinary amounts of natural gas futures contracts within thirty minutes of the close of trading on specified dates. Although these sales drove down the prices that Amaranth received for the contracts that it sold, Amaranth allegedly realized substantial profits on swap agreements purchased on the bet that prices would drop.

Amaranth was one of three significant cases filed by the CFTC in 2007 involving attempted manipulation of the energy markets. In a case against Energy Transfer Partners, L.P. and three of its subsidiaries ("**ETP**"), the agency alleged that ETP sold massive quantities of natural gas for delivery at the Houston Ship Channel hub, and then reported these transactions in an attempt to depress the applicable index price for natural gas. As with Amaranth, the CFTC alleged that ETP executed the sales in order to realize profits from swap agreements purchased on the bet that the index price would drop. Without admitting liability, ETP entered into a consent order in March 2008 and agreed to pay a $10 million penalty.

While the Amaranth and ETP cases involved alleged schemes to depress prices and thereby realize gains on swap agreements structured to benefit from price declines, the CFTC's case against Marathon Petroleum Company LLC ("**MPC**") involved a net purchaser of foreign crude oil who was alleged to have attempted to drive down the price at which it would have to purchase foreign crude oil. In that case, the CFTC alleged that MPC attempted to drive down the price of spot cash West Texas Intermediate ("**WTI**") crude oil for delivery at Cushing, Oklahoma by offering WTI crude oil at prices intended to depress the spot cash assessment. Without admitting liability, MPC entered into a consent order in August 2007 and paid a $1 million penalty.

The CFTC also settled a significant propane gas market cornering case last year against BP Products North America, Inc. ("**BP**"). The agency alleged that BP cornered the market for propane gas transported in the TEPPCO pipeline system by purchasing contracts for substantially all of the February 2004 supply, and then selectively withholding supply to prospective purchasers and selling at inflated prices. In October 2007, without admitting liability, BP entered into a consent order with the CFTC (and a deferred prosecution agreement with the U.S. Department of Justice) and paid fines and penalties totaling $303 million.

The Amaranth case also illustrates the potential for parallel investigations and enforcement proceedings by the Federal Energy Regulatory Commission ("**FERC**"). Last November, FERC held that it had jurisdiction pursuant to Section 4A of the Natural Gas Act to bring an action against Amaranth for the manipulation of the prices of natural gas futures contracts, notwithstanding the CFTC's jurisdiction to police such activity under the CEA. FERC is seeking disgorgement and monetary penalties totaling $291 million. FERC also has pending an enforcement action against ETP relating to the alleged manipulation of wholesale natural gas prices, and is seeking disgorgement and monetary penalties in excess of $167 million.

The SEC also is likely to become involved. Although the SEC lacks jurisdiction over conduct relating to commodities contracts, it could bring an enforcement action for any manipulative activity that results in intentional misstatements on financial statements.

Market participants should assess promptly whether their conduct could be construed as having violated any federal regulations, including by having engaged in manipulative conduct. We anticipate increased scrutiny as Congress and various other federal agencies continue to investigate. Paul Hastings has a group of experienced attorneys who can assist entities that face such inquiries.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

New York

Kenneth M. Breen
212-318-6344
kennethbreen@paulhastings.com

Keith Miller
212-318-6005
keithmiller@paulhastings.com

Thomas R. Fallati
212-318-6094
thomasfallati@paulhastings.com