

Why FERC's Proposed Duty Of Candor Rule Is Problematic

By **Steven Glaser, William Barksdale and Ross Gitlin** (February 3, 2023, 4:50 PM EST)

The Federal Energy Regulatory Commission is considering adopting a new regulation that would prohibit the submission of any inaccurate or false information when communicating with FERC and certain other entities about matters subject to the commission's jurisdiction.

The proposed rule has no scienter or materiality requirements, but it would include an affirmative defense for those who exercise due diligence to prevent the submission of inaccurate and false information.

The proposed rule has been widely criticized as unconstitutional, a solution in search of a problem, beyond FERC's authority and stifling critical communication.

If adopted without modification, the rule would raise significant due process and other concerns, and give FERC wide discretion as to which violations to investigate and penalize.

FERC's Proposed New Rule

The proposed rule would impose a far-reaching new duty of candor requirement.[1] It would prohibit the submission of inaccurate information to FERC and other entities regardless of intent or materiality:

Any entity must provide accurate and factual information and not submit false or misleading information, or omit material information, in any communication with the Commission, Commission-approved market monitors, Commission-approved regional transmission organizations, Commission-approved independent system operators, jurisdictional transmission or transportation providers, or the Electric Reliability Organization and its associated Regional Entities, where such communication relates to a matter subject to the jurisdiction of the Commission, unless the entity exercises due diligence to prevent such occurrences.

This proposed rule is significantly broader than the existing duty of candor rule on which it is modeled.[2]

The existing duty of candor applies only to "sellers" — those with, or seeking, the authority to make wholesale sales of electricity, capacity or ancillary services at market-based rates.[3]

The proposed rule would expand that duty to cover participants in other activities under FERC's jurisdiction and apply to entities and individuals who — unlike sellers — may not be sophisticated or have experience with FERC-jurisdictional markets or activities. Any employee — such as a trader or secretary — or member of the public that engages in a covered communication would be subject to the rule.



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The scope of communications that would be covered is similarly expansive and would reach communications with a large number of organizations, their staff and employees. It would pertain to everything from a landowner's complaint to a gas pipeline company, to a customer's statements in a negotiation with a public utility transmission provider, to a participant's comment in a regional transmission organization stakeholder discussion.

Additionally, the proposed rule is not limited to formal communications and would include "informal and formal communications, verbal or written, and via any method that may be used for transmission." That definition is so broad as to potentially include social media feeds and blog posts that an employee of a covered organization receives.

The justification for the new rule is grounded in the commission's need for "complete, honest, and accurate information" to fulfill its duties. To that end, there are myriad existing rules and statutes that require truthful communications with FERC and others in a range of circumstances.[4]

According to the notice of proposed rulemaking, however, "the current patchwork of requirements is insufficient to encompass all the situations in which" the commission believes accuracy to be necessary.

Common Concerns

Commenters raised a wide range of concerns about the proposed rule during the comment period that ended on Nov. 10.

It would chill important communication.

Market participants will be less likely to voluntarily share information out of fear that they could be subjected to an enforcement investigation. This is an especially acute concern in emergency situations where open communication is vital, but also where there is limited or no time to scrutinize statements made to covered entities.

It is a solution in search of a problem.

The NOPR does not identify any specific instance in which existing rules failed to prevent the submission of inaccurate information.

And while the NOPR lists the types of situations in which inaccurate information could affect the commission's determinations, it does not identify an instance when that in fact happened. Commenters therefore have argued that the proposed rule lacks an adequate factual basis.

The proposed rule violates the First and Fifth Amendments.

Echoing Commissioner James Danly's dissent, commenters are concerned that the proposed rule may violate the First Amendment because its breadth and vagueness would cause individuals to refrain from engaging in protected speech out of fear that they might be subject to liability.

Commenters also asserted that the proposed rule is deficient under a Fifth Amendment due process analysis because it does not provide adequate notice as to what communications are prohibited by the rule and vests unfettered discretion in FERC to punish individuals in an arbitrary and discriminatory manner.

FERC does not have the statutory authority to adopt the rule.

Unlike the existing duty of candor rule, which applies only to a subset of entities over which FERC has clear jurisdiction, the proposed rule would reach entities and individuals who would not otherwise be subject to FERC's jurisdiction. Commenters have argued that the statutory provisions that FERC has referenced do not give it the authority to expand its regulatory reach in the manner that the proposed rule does.

Next Steps

FERC is currently considering whether and how to proceed with the rulemaking. It could abandon or table the proposal, which is what it did in 2019 when it considered expanding the duty of candor to traders of financial transmission rights and virtual products.

Or it could adopt the rule, either in its current form or in a modified version. Commenters have urged FERC to consider adding materiality and scienter requirements or limiting the scope of entities and individuals to whom the rule applies, should the commission move forward with the rulemaking.

If the proposed rule is adopted without modification, it would create significant due process concerns.

Minor inadvertent errors could constitute violations, like submitting a report to FERC that contains a misquote or miscites the page number of a source. The rule is so broad that it might have the effect of turning most market participants into violators.

In practice, FERC and its Office of Enforcement would not be able to investigate and prosecute all potential violations of the proposed rule.

The NOPR states that "even where due diligence cannot be demonstrated, it is not the Commission's intention to investigate or penalize all potential violations of the proposed regulation," and that "as a general matter, we do not intend to penalize inadvertent errors, especially those of limited scope and impact."

But giving such broad discretion to FERC and its Office of Enforcement to decide which participants should be investigated and prosecuted could be problematic.[5]

In nonpublic investigations, we have seen the Office of Enforcement take aggressive positions on the existing duty of candor, and it may do so as well under an expanded duty of candor.

The due diligence defense does not greatly improve the situation. Because it is an affirmative defense, the targets of FERC enforcement matters would bear the burden of proof.

There is very little guidance from FERC as to what would constitute due diligence. Instead, the standard is subjective and variable — it could be little else given the plethora of considerations that FERC will take into account when considering the issue.[6] This would leave many guessing about what practices they should put in place and how to document them.

The rule would also apply to in-house and outside counsel, which led the American Bar Association to express its concern that the proposed rule could undermine state supreme courts' authority to regulate attorneys, conflict with and subvert attorneys' existing ethical obligations, and impose unreasonably heavy burdens on lawyers and their clients.

For example, according to the American Bar Association, in order to meet their burden of proof on the affirmative due diligence defense, "lawyer[s] may be placed in the untenable position of being required to disclose information protected by lawyer-client confidentiality or the attorney-client privilege."

There also is the question of penalties. The statutory maximums of \$1 million per day per violation likely will apply in most cases.[7]

And while FERC is unlikely to set penalty amounts at their maximum limits, it is concerning that FERC could impose multimillion-dollar penalties for unintentional, immaterial errors.

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[1] Duty of Candor, 180 FERC ¶ 61,052 (2022) (NOPR). FERC issued the notice of proposed rulemaking on July 28, 2022. Comments were due on November 10, 2022.

[2] 18 C.F.R. § 35.41(b)

[3] See Skadden Energy Law Handbook at 177 (5th Ed. 2018).

[4] For example, persons appearing before the Commission must conform to the same standards as found in FRCP 11, "which provides that any submission to the court impliedly certifies that factual or legal representations made therein have a reasonable basis in fact or law 'to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances.'" And, as FERC Enforcement reminds every deponent at the beginning of every deposition, it is a crime to lie to officers of the U.S. government, which is punishable by fines and imprisonment.

[5] NOPR (Comm'r Danly, dissenting at P 7) ("For constitutional purposes, what matters is the text of the regulation. The Commission cannot grant itself sweeping discretionary power and then tell the public to 'trust us.'"); *id.* (Comm'r Danly, dissenting at P 9) ("Given the absence of limiting principles, this 'duty of candor' risks 'broadly empowering' the Commission to turn itself into a Ministry of Truth, policing the truth or falsity of an enormous sweep of communications.").

[6] See NOPR at P 43 ("Many facts will bear upon consideration of a due diligence defense including, but not limited to, whether a communication had to be made without sufficient time for additional diligence to be undertaken, the importance and materiality of the communication to the recipient, the duration and consistency of the communication at issue, whether the communication was voluntary or required, whether the communication was in response to a specific request for information or was unsolicited, the size and sophistication of the communicator(s), and the communication's effect on the marketplace or the Commission's regulatory responsibilities."). Likewise, in the proceeding in which FERC adopted the precursor to section 35.41(b), FERC explained that it "believe[s] that a due diligence defense will give sellers sufficient latitude to bring all relevant facts on this issue before the Commission in advance of any action which may be taken against the seller." *Investigation of Terms and Conditions of Pub. Util. Market-Based Rate Authorizations*, 107 FERC ¶ 61,175 at P 96 (2004). This statement was made in response to concerns that the omission of material information should be penalized where the omission is attributable to a legal requirement to protect confidential information.

[7] 16 U.S.C. § 825o-1(b) (Part II of the Federal Power Act); 15 U.S.C. § 717t-1(a) (Natural Gas Act); 15 U.S.C. § 3414(b)(6)(A)(i) (Natural Gas Policy Act). These amounts increase with inflation. Starting in early 2023, the adjusted limitation will be \$1,388,496 per violation, per day. Civil Monetary Penalty Inflation Adjustments, Order No. 886, 182 FERC ¶ 61,002 (2023). Other violations may be subject to lesser penalties. For example, violations of FERC's hydropower licensing regulations under Part 1 of the Federal Power Act are limited to \$10,000 per violation or \$25,075 adjusted by inflation. *Id.*; 16 U.S.C. § 823b(c).