

“pre-arranged, simultaneous, offsetting trades of the same service or product among the same parties.” In addition, Duke Energy requests clarification that “bookout” transactions, in which companies with offsetting delivery obligations resulting from heavy trading activity agree not to deliver to one another the offsetting amounts of energy, not be regarded as a prohibited wash trade.<sup>32</sup>

50. The New York ISO also identifies a transaction which it claims should not fall within the Market Behavior Rule 2(a) prohibition. The New York ISO states that when a market participant mistakenly buys instead of sells, or accidentally buys more energy or capacity than it needs, it may be required to close out of this erroneous position as quickly as possible. The New York ISO states that to do so, the market participant may wish to enter into an offsetting transaction, possibly with the same party or on the same trading platform. Such a transaction, the New York ISO contends, is legitimate and should not be prohibited.

51. To clarify what would and what would not constitute a prohibited wash trade, Merrill Lynch, *et al.* propose that the rule specify what they claim are the three necessary elements of a “wash trade:” (i) A deliberately pre-arranged “pair” of trades; (ii) made at the same time, for the identical price, and at the same delivery point; (iii) between the same legal entities. Reliant proposes that Market Behavior Rule 2(a) be modified to encompass “trades of the same product among the same parties, which trades are pre-arranged to be offsetting and involve no economic risk and no net change in beneficial ownership.” Finally, for the same reason as noted above, commenters propose that an intent standard be adopted as it relates to Market Behavior Rule 2(a).<sup>33</sup>

### 3. Commission Ruling

52. We will adopt Market Behavior Rule 2(a), as proposed, to address, as a prohibited action or transaction:

Pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership (sometimes called “wash trades”).

53. As described in the Western Markets Report, market participants engaged in wash trading during the

period 2000–01 and, as a result, distorted market liquidity as well as other indicators of market performance.<sup>34</sup> As we have noted before and reiterate here, such activity should be considered a serious violation of the authority to sell power at market-based rates. Market Behavior Rule 2(a), therefore, expressly prohibits this activity by identifying the two key elements of a wash trade, *i.e.*, transactions which are (i) prearranged to cancel each other out; and (ii) involve no economic risk.

54. EEI requests clarification that an exchange of power undertaken to avoid the procurement of a transmission service would not be considered a wash trade under our rule. We will grant EEI’s request for clarification. As we understand the issue raised by EEI, the subject transactions would either be at different prices, transfer beneficial ownership, or both. As such, the exchange could not be characterized as a wash trade as we define it.

55. Commenters identify additional transactions which would not meet our definition of a wash trade and therefore would not be prohibited under Market Behavior Rule 2(a). The New York ISO’s identification of trades engaged in to correct a prior error, for example, would not constitute a prohibited wash trade under our rule, because trades such as these would not be “prearranged” to cancel each other out. In addition, each of the transactions described by the New York ISO *would* involve economic risk because the entity attempting to correct its mistake would be at risk for any price change which could occur over the time interval between the two trades. In fact, the purpose of the off-setting trade, in this instance, would be to address the economic risk imposed by the first trade.

56. Other commenters concerns are also misplaced. We do not agree, for example, that a legitimate “sleeve” or “bookout” transaction could be characterized as a prohibited wash trade under our definition. Specifically, a sleeve is not an off-setting trade but rather a mechanism to accomplish a power sale among parties that have not established a credit relationship (involving in the transaction chain a third party seller that possesses the required creditworthiness).<sup>35</sup> Similarly, a “bookout” is not a pre-arranged trade but rather a subsequent arrangement to financially close out a trade that was not

prearranged and was undertaken (and, in fact, closed out) *with* economic risk.

57. In addition, while we agree with EEI, that it may be easier to undertake a wash trade that occurs at the same location, it may also be possible to engage in wash trades that involve more than one location. As such, we decline to revise our proposed rule as EEI requests.

58. Commenters also argue that Market Behavior Rule 2(a) should be revised to include an intent standard, suggesting in effect that a wash trade could be executed without intent (or without an understanding as to its consequence) and should be excused, in this instance. We disagree. Wash trades, by their very nature, are manipulative and purposely so. By definition, parties to a wash trade intend to create prearranged off-setting trades with no economic risk. Thus, we know of no legitimate business purpose attributable to such behavior and no commenter has suggested one. Accordingly, wash trades, under our rule, will constitute a *per se* violation of Market Behavior Rule 2.

### D. Market Behavior Rule 2(b) (Prohibition Against Transactions Predicated on Submission of False Information)

#### 1. Commission Proposal

59. In addition to the prohibition against market manipulation set forth in proposed Market Behavior Rule 2, we also proposed, as a specific action or transaction that would be prohibited, “transactions predicated on submitting false information to transmission providers or other entities responsible for operation of the transmission grid (such as inaccurate load or generation data; scheduling non-firm service or products sold as firm; or conducting ‘paper trades’ where an entity falsely designates resources and fails to have those resources available and feasibly functioning).”

#### 2. Comments

60. Commenters raise three principal concerns regarding the proposed rule: (i) Its failure to include an intent standard; (ii) its apparent prohibition against virtual trading practices already permitted in organized markets; and (iii) its reference to a practice, *i.e.*, to “paper trades,” for which, it is claimed, there is no common definition in the industry.

61. First, commenters assert that an intent standard should be adopted in order to protect sellers from the imposition of sanctions relating to inadvertent or honest errors that were

<sup>32</sup> See also Comments of Ontario Power Generation Inc. at 4.

<sup>33</sup> See *e.g.*, Comments of EPSA, *et al.* at Att. B, p. 3; Comments of EEI at 13; Comments of Pinnacle West at 7; Merrill Lynch, *et al.* at 8; Comments of Duke Energy at 36; Reply Comments of ANP, *et al.* at 3.

<sup>34</sup> Western Markets Report at VI–1.

<sup>35</sup> The two resulting sales (which are only offsetting to the “sleeving” seller) are each with economic risk, with a change in beneficial ownership and, usually, at slightly different prices to reflect the use of the “sleeving” sellers’ credit.