



JONES DAY
COMMENTARY

ENERGY

FERC PROPOSES MODIFYING AND SCALING BACK ITS AFFILIATE STANDARDS OF CONDUCT RULES

On March 21, 2008, the Federal Energy Regulatory Commission (“FERC” or “Commission”) proposed significant revisions to the Standards of Conduct regulations that govern the relationship between transmission providers (both electric and natural gas) and their affiliates.¹ In the Notice of Proposed Rulemaking (“NOPR”), FERC purposefully moves away from the expansive approach to affiliate regulation embodied in the Order No. 2004 Standards of Conduct.² According to FERC Chairman Joseph Kelliher, the new rule will “focus on the actual functions that an employee performs rather than where he or she is listed on a corporate organizational chart.”³ In so doing, the NOPR “focuses the Standards of Conduct rule on the areas where there is the highest risk of affiliate abuse and undue discrimination.”⁴ This approach eliminates the need to classify entities as Energy Affiliates and reinstates important—but not all—elements of the Standards of Conduct as they existed prior to Order No. 2004. The NOPR offers FERC and industry participants the chance to solve some of the troublesome compliance dilem-

mas caused by the Order No. 2004 Standards, but also raises new compliance challenges.

This *Commentary* reviews the history of the Standards of Conduct, summarizes the new NOPR, and identifies some of the open questions about FERC’s proposal. Comments on the NOPR are due by May 12, 2008.

THE ROAD TO REMAND

In 1988, to ensure that all shippers, affiliated and unaffiliated, were treated on a nondiscriminatory basis, FERC adopted the Order No. 497 Standards of Conduct, which regulate the way the transportation function employees of natural gas pipelines interact with “marketing affiliate” employees.⁵ Under Order No. 497, “marketing” meant the “sale of natural gas to any person,” with exceptions for certain types of sales. The Standards required pipelines and their marketing affiliates to function independently and imposed restrictions on the sharing of information.

Building on its experience in the natural gas industry, FERC in 1996 adopted the Order No. 889 Standards of Conduct.⁶ Order No. 889 prohibited electric transmission providers from giving their marketing affiliates or wholesale merchant functions undue preference over nonaffiliated customers. The order also required transmission providers' employees engaged in transmission operations to function independently from other employees of the transmission provider or any of its affiliates engaged in wholesale purchases and sales of electric energy.

In Order No. 2004, FERC found the existing Standards of Conduct insufficient because the nature and scope of energy market participants had changed and the rules did not cover all of the affiliate relationships where an affiliate might take advantage of discriminatory access to the transmission system or transmission system information. Order No. 2004 created a single framework for the Standards of Conduct applicable to electric and natural gas transmission providers and expanded the scope of the Standards to govern the relationships between transmission providers and their "Energy Affiliates." Energy Affiliates of a transmission provider include affiliates that: (1) engage in or are involved in transactions in U.S. energy or transmission markets; (2) manage or control transmission capacity of a transmission provider; (3) buy, sell, trade, or administer electric energy or natural gas in U.S. energy or transmission markets; or (4) engage in financial transactions relating to the sale or transmission of natural gas or electric energy in U.S. energy or transmission markets.

With limited exceptions,⁷ the Order No. 2004 Standards required that: (1) a transmission provider's employees engaged in transmission system operations function independently from employees of its Marketing and Energy Affiliates; and (2) a transmission provider treat all customers on a nondiscriminatory basis and not give preference in the operation of its system to an Energy or Marketing Affiliate.

THE *NATIONAL FUEL* DECISION

On November 17, 2006, in *National Fuel Gas Supply Corp. v. FERC*,⁸ the D.C. Circuit vacated and remanded Order No. 2004 as applied to natural gas pipeline transmission providers. The court found insufficient record evidence to justify FERC's expansion of the Standards of Conduct to govern

pipelines' relationships with nonmarketing "Energy Affiliates," which included producers, gatherers, and local distribution companies.

In response to the court's opinion, FERC issued interim Standards of Conduct for natural gas transmission providers on January 9, 2007.⁹ In the Interim Rule, FERC largely re promulgated the Order No. 497 Standards, while retaining some provisions of the Order No. 2004 Standards that were not vacated in *National Fuel*. The Interim Rule made no modifications to the Standards of Conduct as they apply to electric transmission providers.

THE JANUARY 2007 NOTICE OF PROPOSED RULEMAKING

In January 2007, as a long-term response to the *National Fuel* decision, FERC proposed to revise its Standards of Conduct for both electric and natural gas pipeline transmission providers. As to electric transmission providers, the January 2007 proposed rule asked whether the Standards of Conduct should be revised to govern only the relationship between electric transmission providers and their marketing affiliates, as opposed to the broader category of Energy Affiliates. In addition, to avoid conflicts between the Standards of Conduct and electric utilities' need to conduct state-mandated integrated resource planning ("IRP") and competitive solicitations, FERC proposed to create two categories of employees—Planning Employees and Competitive Solicitation Employees. Subject to restrictions, those employees would be able to access nonpublic transmission information and interact with both transmission employees and Marketing and Energy Affiliate employees for IRP and/or competitive procurement activities focused on a public utility's bundled retail load obligations. As to natural gas transmission providers, FERC proposed to make the Interim Rule permanent.

THE MARCH 21 NOPR

In the NOPR, FERC abandons the "incremental" reforms outlined in its January 2007 proposal in favor of "broader reforms." According to FERC, the Order No. 2004 Standards of Conduct have proven complex and unworkable, thereby: (1) frustrating compliance because the industry's focus

has been diverted from the need to properly separate the employees that market commodities from those that perform transmission functions; and (2) sacrificing legitimate vertical integration efficiencies—to the ultimate detriment of consumers. FERC therefore proposes to streamline and clarify the Standards by: (1) focusing on “marketing” rather than the more expansive concept of “Energy Affiliate” activities; and (2) returning to a “functional” or “employee” separation approach (focusing on the functions performed by individual employees) rather than Order No. 2004’s “corporate” separation approach (focusing on the primary business function of an entire division or corporation). FERC proposes three core Standards of Conduct elements: the independent functioning rule, the no-conduit rule, and the transparency rule.

THE INDEPENDENT FUNCTIONING RULE. Each of the prior Standards of Conduct rules included an independent functioning requirement. The NOPR departs from the “corporate” functional approach of Order No. 2004 and states that it is returning to the “employee” functional approach of Order Nos. 497 and 889. The NOPR recognizes that the corporate functional approach is too broad because it includes all employees of a Marketing or Energy Affiliate, even if the employee is not engaged in marketing activities. The employee functional approach “accomplishes directly the goal of identifying which employees ought not to interact with one another, whereas the corporate functional approach attempts to accomplish that objective indirectly, by focusing on the nature of the employing entity.”¹⁰

The NOPR defines two types of employees that must function independently: “transmission function employees” and “marketing function employees.” The NOPR proposes to retain the prohibition barring marketing function employees from conducting transmission functions or having discriminatory access to the transmission provider’s system control center, and proposes to add the converse prohibition barring transmission function employees from conducting marketing functions.

TRANSMISSION FUNCTION EMPLOYEES. The NOPR defines a transmission function employee as an employee, contractor, consultant, or agent of a transmission provider who “actively and personally” engages in transmission functions.¹¹ “Transmission functions” are defined as “transmission system operations and the planning, directing, organizing or carry-

ing out of transmission operations, including the granting and denying of transmission service requests.”¹²

An employee’s actual function (not his or her job title) will control whether the employee is a “transmission function employee.” If an employee spends any but a *de minimis* amount of time engaged in transmission functions, he or she will be considered a transmission function employee for purposes of the NOPR. However, the definition excludes officers, directors, and other supervisory employees who do not “actively and personally engage in transmission functions.”¹³ For example, if a transmission department supervisor has general responsibility for “overseeing system control personnel, but does not himself engage in system operations or grant or deny transmission service requests,” he will not be a transmission function employee.¹⁴ But if such individuals have access to transmission function information, they will be barred from sharing it with marketing function employees under the no-conduit rule discussed below.

Open Questions About the NOPR:

What activities will cause an officer, director, or supervisory employee to be “actively and personally” involved in either transmission functions or marketing functions, and hence subject to the independent functioning rule? In the context of Order No. 2004 and the Interim Rule, the scope of the exemption for “shared senior officers” has generated considerable debate. It is not clear how these same issues will be resolved under the NOPR. For example, if a supervisory employee signs a transmission service contract or has a single, high-level, “company-to-company” meeting with a potential customer, is that employee “actively and personally” involved in transmission functions? FERC’s one example provides some basis for optimism by confirming that a transmission department supervisor who has “general responsibility for overseeing system control personnel, but does not himself engage in system operations or grant or deny transmission service requests” would not be a transmission function employee.

MARKETING FUNCTION EMPLOYEES. The NOPR does not define several marketing-related terms that are defined in the current Standards, and instead includes definitions of “marketing function employee” and “marketing function.” “Marketing functions” are defined as “the sale for resale in

interstate commerce, or the submission of offers or bids to buy or sell natural gas or electric energy or capacity, demand response, virtual electric or gas supply or demand, or financial transmission rights in interstate commerce,” all subject to certain exemptions.¹⁵ Sales of electric energy include sales of ancillary services.¹⁶ The “sit[ing] for generating capacity” is not a marketing function.¹⁷

“Marketing function employee” is defined as an employee, contractor, consultant, or agent of a transmission provider or of an affiliate of a transmission provider who “actively and personally engages in marketing functions.”¹⁸ An employee who performs “merely a planning function” and is not “engaged in making wholesale offers, bids or sales” would not be a marketing function employee.¹⁹

Open Questions About the NOPR:

(1) *Would an employee who buys or offers to buy natural gas (for use in generating electricity or in any other use) be a “marketing function employee?”* Under Order No. 889, neither buying nor selling natural gas was a “marketing affiliate” function as it relates to an electric utility transmission provider. A natural gas marketer was not subject to the Order No. 889 Standards with respect to an affiliated electric transmission provider. Under Order No. 497, only selling natural gas—not purchasing gas—was a “marketing affiliate” function as it relates to an interstate pipeline transmission provider.

(2) *Would an employee who buys or sells electric energy or capacity be a “marketing function employee” as to an interstate pipeline transmission provider?* Under Order No. 497, electric “marketers” were not “marketing affiliates” for purposes of the natural gas Standards of Conduct. In *National Fuel*, the court vacated Order No. 2004 as to interstate pipelines because FERC had “provided no evidence of a real problem with respect to pipelines’ relationships with non-marketing affiliates.” The NOPR provides no basis for treating an employee that buys and sells electric energy or capacity as a “marketing function employee” of an interstate pipeline transmission provider.

(3) *Can an employee be a “marketing function employee” if the affiliate conducts no transactions on the transmission provider?* The Order No. 497 Standards of Conduct regulated the relationship between an interstate pipeline

and a marketing affiliate only if, based on a transaction-by-transaction evaluation, the marketing affiliate conducted transportation transactions on that affiliated interstate pipeline. For example, an LDC could sell gas “off system” without becoming a “marketing affiliate” so long as the LDC did not transport the natural gas being sold on an affiliated pipeline. Although the NOPR retains the “conducting transportation transactions” limitation,²⁰ it is unclear how this limitation will be applied in the context of the NOPR’s new focus on “marketing function employees” rather than on “marketing affiliates.”

(4) *Are electric generation-related activities—such as building, buying, or operating a power plant—“marketing functions?”* Under the Order No. 2004 regulations, “marketing” did not expressly include “generation” activities such as building, buying, or operating a power plant. Nonetheless, in Order No. 2004 “Frequently Asked Questions” and in the January 2007 NOPR, FERC seemed to equate “generation” and “marketing” activities. The NOPR suggests that employees engaged solely in generation operations would not be engaged in “marketing functions.” These issues may need to be further clarified.

(5) *Are there terms of art in the definition of “marketing function” that need to be further explained?* For example, the phrase “electric energy or capacity” was not used in the Order No. 2004 Standards or in the January 2007 NOPR, nor were the phrases “demand response,” “virtual electric or gas supply,” or “firm transmission rights.” Few, if any, of these phrases have only a single, commonly accepted definition. Such clarity may be particularly appropriate given that the proposed rules would apply to both interstate pipelines and electric utilities.

Consistent with the definition of transmission function employees, if an employee spends any but a *de minimis* amount of time engaged in marketing functions, he or she will be considered a marketing function employee. A supervisor, officer, or director who is not actively and personally engaged in marketing functions will not be considered a marketing function employee.²¹ The NOPR would revise the definition of “affiliate” to conform to the current definition set forth in 18 C.F.R. § 35.43(a)(1), a recently adopted regulation addressing affiliate cross-subsidization.²²

The NOPR would exempt the following activities from the definition of marketing function: (1) bundled retail sales; (2) incidental purchases or sales of natural gas to operate interstate natural gas pipeline transmission facilities; (3) sales of natural gas “solely from the transmission provider’s own production”; (4) sales of natural gas “solely from the transmission provider’s own gathering or processing facilities”; and (5) sales by an intrastate natural gas pipeline or local distribution company “making an on-system sale.”²³ The NOPR would add an exemption for Provider of Last Resort sales as part of the bundled retail sales exemption.²⁴

Open Questions About the NOPR:

What does the NOPR mean when it exempts sales of natural gas solely from “the transmission provider’s” own gathering or processing facilities? Order No. 2004 and the Interim Rule exempted a “seller [that] is selling gas solely from its own gathering or processing facilities.” Why has the NOPR focused on sales from the transmission provider’s facilities rather than sales from the facilities of affiliated gatherers, processors, or producers (the companies that are likely to be making such sales)?

Although the January 2007 NOPR contemplated applying the Standards to asset managers or agents, FERC concludes that there is no reason to expressly address asset managers or agents in the proposed Standards. The definition of marketing function employee reaches all employees of affiliates directly engaged in “marketing,” regardless of whether the affiliate is the regulated company itself, a contractor, consultant, agent, or asset manager.

TRANSMISSION PLANNING AND RELIABILITY. FERC and commentators have struggled with how to reconcile the Standards of Conduct with utilities’ need to conduct integrated resource planning. In the NOPR, FERC concludes that adopting the “employee” functional approach resolves such concerns. An employee that performs a planning function is not “engaged in” making wholesale offers, bids, or sales, and so a planning employee can receive information from both “marketing function employees” and “transmission function employees.”

SHARED EMPLOYEES. The NOPR would dispense with Order No. 2004’s category of “shared employees,” which allows transmission providers to share employees with Energy and

Marketing Affiliates if the employee provides support functions (such as legal, accounting, and information technology support). Under the NOPR, such employees would not fall within the scope of the independent functioning rule as long as they are acting in support functions and are not acting as transmission function employees or marketing function employees. However, support employees would remain subject to the no-conduit rule and would be prohibited from passing nonpublic transmission function information to marketing function employees.

Under the NOPR, field employees will no longer be exempt from the independent functioning rule. According to the Commission, the “field and maintenance” exemption will not be needed because such employees will not be in a position to interact with marketing function employees.

Open Questions About the NOPR:

If field and maintenance employees could be shared under the Order No. 2004 Standards, why are they subject to the NOPR’s proposed Standards?

PERMITTED INTERACTIONS. Although the number of operational employees that would qualify as “marketing function employees” will be reduced under the NOPR, FERC recognized that there may be instances when transmission function employees must communicate with marketing function employees. For example, where the marketing function of a public utility both markets the company’s electric power and operates its generating plants, it is essential that the employees supervising the generating plant’s operation be able to discuss the plant’s operational status with transmission function employees. In addition, several Reliability Standards promulgated pursuant to the Energy Policy Act of 2005 require an electric transmission provider to coordinate operations with entities that may include marketing affiliates and their “marketing function employees.” To address such situations, the NOPR identifies two types of information that would be exempt from the independent functioning rule: (1) information regarding generation necessary to perform generation dispatch, and (2) information necessary to maintain or restore operation of the transmission system.

Exchanges of information pursuant to these exceptions should be made only to the same extent that a transmission provider would exchange information with similarly situated

marketing function employees of a nonaffiliated entity. In order to prevent and monitor for potential abuse, the NOPR proposes that, whenever transmission function employees and marketing function employees “exchange certain information,” the transmission provider must “make and retain a contemporaneous record of all such exchanges except in emergency circumstances, in which case a record must be made of the exchange as soon as practicable after the fact.”²⁵ The record may consist of handwritten or typed notes, electronic records such as emails and text messages, recorded telephone exchanges, and similar records, and must be retained for five years.

Open Questions About the NOPR:

Does the “contemporaneous recording” requirement apply to transaction-specific communications between transmission function employees and marketing function employees? Proposed Section 358.7(h) identifies only two types of “permitted” information exchanges: information regarding generation dispatch, and information to maintain or restore operation of the transmission system. But information also may be exchanged between transmission function employees and marketing function employees pursuant to proposed Section 358.7(b), which permits the exchange of information that “relates solely to a marketing function employee’s specific request for transmission service.” It is not clear whether a record of such “transaction-specific” communications must be made and retained.

THE NO-CONDUIT RULE

In addition to prohibiting transmission function employees from disclosing nonpublic transmission information to marketing function employees, the NOPR would prohibit: (1) marketing function employees from receiving nonpublic transmission function information from any source; and (2) employees of any affiliate from acting as conduits for sharing nonpublic transmission information with a marketing function employee. As with the existing regulations, the Standards would formally apply only to transmission providers.²⁶ This places the burden on transmission providers, and in particular on Chief Compliance Officers (“CCOs”), to ensure compliance. It is the CCO who is “responsible, in the first instance, for fielding any questions from employees regarding the

nature of transmission function information or the persons to whom it may be passed, for preventing prohibited exchanges of information, and for curing any prohibited exchanges by public posting of the information.”²⁷

Open Questions About the NOPR:

How will transmission providers actively ensure compliance with the no-conduit rule? The proposed rules directly regulate only transmission providers, but impose duties on employees of other affiliates. How will FERC enforce the duties imposed on nonjurisdictional affiliates that are, nonetheless, subject to the no-conduit rule?

TRANSPARENCY AND POSTING REQUIREMENTS

The NOPR maintains public posting as the “cure” for a prohibited disclosure (unless the improperly disclosed information is confidential customer information, which should not be posted). Although organizational charts would no longer be required, most of FERC’s existing posting requirements would be retained, including the requirements to post: the names and addresses of affiliates with marketing function employees; shared facilities; job titles and descriptions for transmission function employees and transfers of employees between transmission function and marketing function positions; and discounts. A transmission provider would be required to post each waiver or exercise of discretion within one business day, and would be required to maintain a written log of all such waivers or exercises of discretion. The log must be maintained for five years from the date of the waiver or exercise of discretion.

Open Questions About the NOPR:

*What is the difference between a “waiver” and an “exercise of discretion”? Has FERC justified the requirement to post a notice of “each exercise of discretion” and to log each “waiver” and “exercise of discretion”? These issues were raised in the Order No. 2004 proceeding. The logging of “exercises of discretion” was challenged by interstate pipelines in the *National Fuel* appeal, and challenged again in the context of the Interim Rule and the January 2007 NOPR. Without any explanation, the new NOPR retains—and perhaps further expands—the challenged notice and posting requirements.*

***PER SE* RULES AND GENERAL PROHIBITIONS**

The NOPR characterizes the Standards of Conduct as establishing “*per se*” rules.²⁸ FERC does not define what “*per se*” means in this context, but states that “failure to comply with a *per se* rule of the Standards automatically establishes a sanctionable violation.”²⁹ FERC also explains that the combination of public disclosure and contemporaneous recording required by the transparency rule will provide the “information needed to identify violations of the *per se* rules of the Standards, for which no further investigation would be needed.”³⁰ FERC contrasts such *per se* rules with the requirements of Sections 205 and 206 of the Federal Power Act and Sections 4 and 5 of the Natural Gas Act, which “would require an investigation into both the facts and the surrounding circumstances to determine if, in fact, an undue discrimination occurred.”³¹

At the same time, the NOPR would add a general prohibition against “undue discrimination and undue preference” based on the language of Sections 205 and 206 of the Federal Power Act and Sections 4 and 5 of the Natural Gas Act.³²

Open Questions About the NOPR:

What is the relationship between the new general prohibition on “undue discrimination and undue preference” and the “per se” nature of the Standards of Conduct?

TRAINING

The NOPR retains Order No. 2004’s training requirement. The NOPR states that “most employees should receive some training, as all employees are forbidden from passing designated information to prohibited employees[.]”³³ However, the “bulk of the training” will be concentrated on transmission function employees, marketing function employees, and those employees who are privy to transmission function information (including lawyers, accountants, risk management, and rate design personnel with access to such information).³⁴ Transmission providers will be responsible for training these employees annually.

Open Questions About the NOPR:

When the NOPR states that “most employees” must be trained, is FERC referring to employees of the transmission provider or the employees of all affiliated companies?

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ENDNOTES

- 1 *Standards of Conduct for Transmission Providers*, 73 Fed. Reg. 16,228 (March 27, 2008), 122 FERC ¶ 61,263 (2008) (“NOPR”).
- 2 *Standards of Conduct for Transmission Providers*, Order No. 2004, FERC Stats. & Regs. ¶ 31,155 (2003), *reh’g*, Order No. 2004-A, FERC Stats. & Regs. ¶ 31,161 (2004), *reh’g*, Order No. 2004-B, FERC Stats. & Regs. ¶ 31,166 (2004), *reh’g*, Order No. 2004-C, FERC Stats. & Regs. ¶ 31,172 (2005), *reh’g*, Order No. 2004-D, 110 FERC ¶ 61,320 (2005) (collectively “Order No. 2004”), *remanded as it applies to natural gas pipelines sub nom. National Fuel Gas Supply Corporation v. FERC*, 468 F.3d 831 (D.C. Cir. 2006).
- 3 See Statement of Chairman Joseph T. Kelliher, Docket No. RM07-1-000, March 20, 2008, at p. 2.
- 4 *Id.* at pp. 1-2.
- 5 *Inquiry Into Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines*, Order No. 497, FERC Stats. & Regs. ¶ 30,820 (1988) (subsequent history omitted) (“Order No. 497”).
- 6 *Open Access Same-Time Information System (formerly Real-Time Information Networks) and Standards of Conduct*, Order No. 889, FERC Stats. & Regs. ¶ 31,035 (1996), *reh’g*, Order No. 889-A, FERC Stats. & Regs. ¶ 31,049 (1997), *reh’g denied*, Order No. 889-B, 81 FERC ¶ 61,253 (1997) (“Order No. 889”).
- 7 For example, a transmission provider was permitted to share support and field and maintenance employees, senior officers and directors, and risk management employees with their Marketing and Energy Affiliates, provided that such employees did not act as “conduits” for sharing nonpublic transmission information with Marketing or Energy Affiliates.
- 8 468 F.3d. 831 (D.C. Cir. 2006).
- 9 *Standards of Conduct for Transmission Providers*, Order No. 690, FERC Stats. & Regs. ¶ 31,237 (2007), *on clarification and reh’g*, Order No. 690-A, FERC Stats. & Regs. ¶ 31,243 (2007) (“Interim Rule”).
- 10 NOPR at P 28.
- 11 See proposed 18 C.F.R. § 358.3(i).
- 12 See proposed 18 C.F.R. § 358.3(h).
- 13 See proposed 18 C.F.R. § 358.3(i).
- 14 NOPR at P 34.
- 15 See proposed 18 C.F.R. § 358.3(c).
- 16 NOPR at n.53.
- 17 *Id.*
- 18 See proposed 18 C.F.R. § 358.3(d).
- 19 NOPR at P 32.
- 20 See proposed 18 C.F.R. § 358.1 (“(a) This part applies to any interstate natural gas pipeline that transports gas for others pursuant to subpart A of part 157 or subparts B or G of part 284 of this chapter and conducts transmission transactions with an affiliate that engages in marketing functions.”).
- 21 See proposed 18 C.F.R. § 358.3(d).
- 22 See proposed 18 C.F.R. § 358.3(a).
- 23 See proposed 18 C.F.R. § 358.3(c)(1)-(5).
- 24 See proposed 18 C.F.R. § 358.3(c)(1).
- 25 See proposed 18 C.F.R. § 358.7(h).
- 26 See, e.g., proposed 18 C.F.R. § 358.1(b) (“This part applies to any public utility that owns, operates, or controls facilities used for the transmission of electric energy in interstate commerce.”).
- 27 See NOPR at P 48.
- 28 See *id.* at P 20.
- 29 *Id.* at n.22.
- 30 *Id.* at P 55.
- 31 *Id.* at n.22.
- 32 See proposed 18 C.F.R. § 358.2.
- 33 NOPR at P 49.
- 34 *Id.*

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