FERC's Anti-Manipulation Efforts Need Better Balance

Andrew R. Corcoran

Numerous industry commentators have expressed skepticism and concern regarding the Federal Energy Regulatory Commission's (FERC's) interpretation of what constitutes market manipulation.[1] Some have also challenged FERC's procedural tactics.[2] Although FERC has to date disagreed with most of these criticisms,[3] this article recommends that FERC consider whether certain reforms would achieve a better balance between vigorous enforcement and fair treatment of those being prosecuted.

Broad interpretations of the substantive standards and narrow interpretations of defendants' procedural rights may have negative unintended consequences.

The current combination of broad interpretations of the substantive standards and narrow interpretations of defendants' procedural rights may have negative unintended consequences. First, this approach may cause a significant reduction in market participation, thereby harming liquidity. Second, the approach fosters industry distrust of FERC that could hamper its overall effectiveness.

Although FERC must continue to investigate and prosecute manipulative conduct, there are certain basic measures that may help FERC strike a better balance and thus ensure it is perceived as fair both as a regulator and an *enforcer*.

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FERC'S CATCH-ALL ANTI-MANIPULATION RULE

FERC's primary purpose with respect to regulated markets is—and always has been—to promote just and reasonable rates.[4] It is therefore obvious that FERC can and should attempt to prevent and prosecute manipulative conduct because such conduct—by definition—is intended to distort price signals. Historically, FERC has only possessed nominal authority to prevent manipulation and "few remedies to address misconduct by market participants."[5] However, the Energy Policy Act of 2005 (EPAct 2005) dramatically changed the legal landscape by substantially increasing FERC's authority over market manipulation.[6]

In addition to expanding FERC's substantive authority, EPAct 2005 also increased FERC's remedial authority by raising the maximum civil penalty that FERC could assess from $11,000 per day under the Federal Power Act and $5,500 per day under the Natural Gas Policy Act of 1978 to $1 million per violation per day.[7] In 2006, pursuant to its expanded authority, FERC finalized its Anti-Manipulation Rule, Order No. 670. In doing so, FERC broadly interpreted its authority by adopting expansive definitions of both substantive requirements of its Anti-Manipulation Rule: fraud and intent.[8] As FERC has noted in justifying this approach:

> Both the breadth of Congress' authorization to the Commission and the breadth of the Anti-Manipulation Rule itself are a response to what courts have long recognized:

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> the impossibility of foreseeing the "myriad means" of misconduct in which market participants may engage. (*In Re Make-Whole Payments and Related Bidding Strategies*, 144 FERC ¶61,068 at PP 83–84 [2013])

With respect to fraud, FERC rejected traditional common-law definitions of fraud. Instead, FERC based its definition on a controversial interpretation of the Supreme Court's holding in *Dennis v. United States*.[9] Specifically, FERC held that "fraud" includes "any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market."[10] FERC has relied on this broad interpretation in finding manipulation even with respect to conduct that is neither fraudulent in the conventional sense nor specifically prohibited by the applicable market rules.[11]

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With respect to intent, FERC rejected "requests to incorporate a specific intent standard into the Final Rule" and instead held that "recklessness satisfies the scienter element of the Final Rule."[12] (The intent requirement is satisfied by a showing of "knowing, intentional, or reckless misconduct.") As a result, FERC may arguably find that market manipulation exists where, for example, an entity fails to adopt adequate internal controls to identify potential manipulative conduct or a trader fails to recognize unintended but predictable collateral consequences of otherwise legitimate trading.

FERC'S NARROW INTERPRETATION OF JUDICIAL PROCEDURES

FERC's Office of Enforcement has made investigation and prosecution of market manipulation a top priority.[13]

This effort has resulted in several recent record-setting penalty assessments and settlements for alleged manipulative conduct.[14] In the process, however, FERC Enforcement has taken some controversial positions on key procedural issues. Perhaps the most controversial and most important of FERC's recent procedural positions is its interpretation of the appropriate judicial procedures under Section 31(d)(3) of the Federal Power Act (FPA).[15]

FERC has recently taken the position that investigative targets that opt for review *de novo* (anew) of law and fact in federal district court pursuant to FPA Section 31(d)(3) are not entitled to a full trial on the merits—as they would be before an administrative law judge—but instead only entitled to judicial review analogous to that provided under the Administrative Procedures Act.[16] This interpretation is still subject to judicial review, and it stands in stark contrast to FERC's prior statements suggesting that the procedures pursuant to FPA Section 31(d)(3) are parallel to those before an administrative law judge and that defendants who elect for such district court proceedings are entitled to a full trial on the merits.[17]

Regardless of the merits, FERC's shift in position in the context of ongoing litigation is troubling.[18]

NEGATIVE UNINTENDED CONSEQUENCES

The combination of FERC's sweeping substantive definition of manipulative conduct and FERC's limited interpretation of the appropriate judicial procedures under FPA Section 31(d)(3) can create negative unintended consequences.

First and foremost, FERC's efforts to deter manipulative conduct may be *too* effective, as they may discourage not just manipulative conduct but also overall market participation. This could result in a substantial reduction in market liquidity. As industry observers have noted, recent regulatory changes have substantially increased the costs associated with energy trading.[19]

Such costs are certainly in part the result of FERC's aggressive approach and uncertain standards.[20] The potential for reduced participation does not appear to be a mere theoretical risk. Indeed, a number of large market participants have already left the market after finding themselves the target of FERC investigations.[21] Moreover, available data has indicated significant reductions in at least some markets.[22] Among other things, reduced market participation could reduce market liquidity and increase volatility.

Second, FERC's enforcement policies can foster industry distrust of FERC. FERC certainly has the power to compel industry cooperation and action. But as is the case with any regulatory regime, it is better to also have the industry's respect, trust, and cooperation.[23] If the perception is that FERC's Office of Enforcement is aggressively pursuing manipulation cases with respect to conduct that does not fit into and is not analogous to traditional industry notions of what constitutes manipulation, it is unlikely that respect, trust, and cooperation will abound.

The result is that FERC will likely be less efficient *and* less effective in its efforts to investigate, penalize, and deter manipulative conduct.

FINDING BALANCE

There is no question that FERC has been charged with preventing manipulation in the wholesale energy markets.

However, it is unclear whether FERC's current approach strikes the proper balance between regulatory fairness and prosecutorial deterrence. Historically FERC arguably did not have adequate authority to deter manipulative conduct and thus was not aggressive enough. However, the pendulum may have now swung too far in the other direction.

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FERC should take steps to help it achieve a better balance. None of these would seriously hamper its ability to pursue truly manipulative conduct. However, they would likely alleviate the unintended effects discussed above.

Reconsider and Clarify Standards

First, FERC can and should reconsider its substantive standards.

With respect to its nontraditional definition of fraud, FERC should reconsider adopting a more traditional standard that requires some form of actual deceit or trickery. Doing so will not significantly hamper FERC from pursuing manipulative conduct, but it will provide some certainty to market participants regarding what does and does not cross the line. Alternatively, if FERC does not adopt a more-traditional common-law definition of fraud, FERC should at a minimum clarify the types of conduct it deems to improperly interfere with a well-functioning market. Given that, unlike in the securities context, FERC is still developing a body of precedent, it may be useful to provide some hypothetical examples of borderline conduct that does and does not cross the line.

FERC could also consider establishing safe harbors for some common forms of conduct to provide greater certainty regarding the substantive standards. In the context of related-positions cases,[24] for example, FERC could consider adopting numerical and clearly enumerated leverage thresholds that make clear that trading of related positions will not be deemed manipulative if it falls within certain limits. FERC's current position that trading must be independently profit-seeking is overly subjective and risks punishing otherwise legitimate—albeit ineffective or unwise—trading as it may encourage the assumption of intent through hindsight based on profitability.[25]

Unchecked, this standard risks prosecuting or at least wasting resources investigating merely ineffective as opposed to manipulative trading. However, leverage is one common element of related-positions cases that can be enumerated and thus may provide some objective measure. The manipulation of related positions is not theoretically profitable without leverage.[26]

Accordingly, adopting specific leverage ratio safe harbors may both (1) discourage market participants from taking positions that incentivize manipulative conduct and (2) provide some market certainty. Such a safe-harbor program may be particularly effective if combined with stronger position reporting requirements, thus allowing FERC to better monitor for truly manipulative conduct.[27] In fact, the safe harbor could be contingent on requiring market participants to confidentially report their positions, thus offering an incentive for voluntary reporting. While market participants can obviously still exceed such ratios or not report their positions, they do so with the knowledge that they will not fall into the safe harbor and thus that their conduct may then be subject to greater scrutiny.

Similarly, FERC could create a disclosure safe harbor whereby market participants will not be prosecuted for manipulating FERC-approved tariff rules if they provide FERC and/or the pertinent market monitor advance notice of their intended trading strategy. Such disclosures could be provided nonpublicly to protect proprietary information. If upon examining such disclosures, FERC believes that such conduct is inappropriate or undesirable, FERC could implement rulemaking proceedings to change the tariff and provide

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notice that going forward FERC intends to prosecute any such conduct as market manipulation.

This approach will not only provide market participants with certainty but will also help FERC identify and remedy poorly designed tariff rules. Providing such safe harbors will help define what constitutes reckless conduct sufficient to satisfy FERC's intent requirement. If market participants fail to stay within designated safe harbors, these participants take the risk that their conduct will be deemed manipulative and that their intent may be established by their reckless failure to stay within the safe harbors or by the participants' reckless failure to take appropriate measures to ensure appropriate market behavior when operating outside of such safe harbors.

Better Review Procedures

Second, with respect to its procedural positions, specifically its interpretation of the appropriate scope of an additional review pursuant to FPA Section 31(d)(3), FERC should strive to meet its strategic goal of "serving the American public through integrity, *openness, and transparency*" by promoting procedures that facially satisfy traditional notions of due process and fair play.[28]

Whether such openness and transparency is with the greater American public or an investigative target, it is a necessary and desirable goal. Understandably, FERC cannot be fully open and transparent with investigative targets during the entire process. However, FERC may have shifted the rules too far in its own favor and should support a more open and transparent process during the public stage of an investigation.

As FERC has suggested by pursuing cases such as *Powhatan Energy Fund*, just because something is not prohibited does not mean anyone can and should do it. Such is the case with respect to some of FERC's procedural positions. Assuming for the sake of argument that FERC's interpretation of FPA Section 31(d)(3) is permissible, it still does not mean it is the standard FERC should endorse. Allowing manipulation claims to be tested through an open, transparent, and thorough judicial process is more costly, but such costs are worth ensuring that common notions of fairness are satisfied.

CONCLUSION

While each of the changes proposed above has some associated cost, the cost of doing nothing is arguably greater. Unless it takes some action, FERC not only risks harming the very market it is charged with protecting but also risks enduring harm to its reputation as a fair and reasonable regulator.

More importantly, none of the above changes seriously risks hampering FERC's goal of identifying, prosecuting and deterring manipulative conduct.

NOTES

1. See, e.g., Pirrong, C. (2010). Energy market manipulation: Definition, diagnosis and deterrence. *Energy Law Journal, 31*, 1–20 (discussing why alleged "market power manipulation" schemes do not involve fraud); *FERC v. Powhatan Energy Fund, LLC: Legal Materials, Independent Expert Opinions and More*. Retrieved from http://ferclitigation.com (collecting numerous experts' concerns regarding FERC's positions on a particular manipulation case).
2. See, e.g., Scherman, W. S., Johnson, B. C., & Fleischer, J. J. (2014). The FERC enforcement process: Time for structural due process and substantive reforms, *Energy Law Journal, 35*, 101–149.
3. See Murphy, A., Hettenbach, T., & Olson, T. (2014). The FERC enforcement process. *Energy Law Journal*, 35, 283–321.
4. See *FERC Strategic Plan for FY 2014–FY 2018*. (2014, March). Retrieved from http://www.ferc.gov/about/strat-docs/FY-2014-FY-2018-strat-plan.pdf; p. 1 (FERC's "Mission" is to "[a]ssist consumers in obtaining reliable, efficient and sustainable energy services at a reasonable cost through appropriate regulatory and market means" and, thus, with respect to energy markets FERC's focus is "ensur[ing] just and reasonable rates, terms, and conditions.").
5. FERC. (2005, March). *Energy market oversight and enforcement: accomplishments and proposal for enhanced penalty authority*. Retrieved from http://www.ferc.gov/legal/maj-ord-reg/land-docs/03-2005-cp-rept.pdf; see also Kelliher, J. (2005). Market manipulation, market power, and the authority of the Federal Energy Regulatory Commission. *Energy Law Journal, 26*, 1–33 (former FERC chairman discussing the Commission's "insufficient" authority over market manipulators prior to 2005).
6. See *Prohibition of Energy Mkt. Manipulation*, Order No. 670, FERC Stats. & Regs. ¶31,202 at P 6, *reh'g denied*, Order No. 670-A, 114 FERC ¶61,300 (2006) (codified at 18 CFR pt. 1c) (discussing Sections 315 and 1283 of EPAct 2005, which amended the Natural Gas Act and Part II of the Federal Power Act (FPA) by adding "virtually identical" prohibitions on "the use or employment of manipulative or deceptive devices or contrivances in connection with the purchase or sale of natural gas, electric energy, or transportation or transmission services subject to the jurisdiction of the Commission").
7. See EPAct 2005 §§ 314(b) & 1284(e)(1).
8. As the Commission noted in Order No. 670, once the jurisdictional requirements are satisfied, a claim for market manipulation exists "where an entity: (1) uses a fraudulent device, scheme or artifice, or makes a material misrepresentation or a material omission as to which there is a duty to speak under a Commission-filed tariff, Commission order, rule or regulation, or engages in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) with the requisite scienter." Order No. 670, FERC Stats. & Regs. ¶31,202 at P 49.

9. 384 U.S. 855 (1966). Order No. 670, FERC Stats. & Regs. ¶31,202 at P 50 (citing *Dennis*, 384 U.S. at 861, for the proposition that "fraud within the meaning of a statute need not be confined to the common law definition of fraud: any false statement, misrepresentation or deceit"); *see also Deutsche Bank Energy Trading, LLC*, 140 FERC ¶61,178 at App. A, n.78 (2012) (citing *Dennis*, 384 U.S. at 855. *Dennis* did not overturn the Supreme Court's prior cases, which held that to demonstrate a conspiracy to defraud the United States requires some showing of "deceit, craft or trickery, or ... dishonest[y]." *Hammerschmidt v. United States*, 265 U.S. 182, 188 (1924). Moreover, subsequent to *Dennis*, the lower courts have consistently rejected analogous efforts to rely on *Dennis* to avoid proving fraud in cases about defrauding the government. See, e.g., *United States v. Knapp*, 25 F.3d 451, 455 (7th Cir. 1994) (discussing the holdings of *Hammerschmidt*, 265 U.S. 182, which was not overturned by the holding in *Dennis*, and holding that "a defendant cannot be found guilty of defrauding the United States without some showing of fraud"); *United States v. Caldwell*, 989 F.2d 1056 (9th Cir. 1993) ("holding that [t]he Supreme Court has made it clear that 'defraud' is limited only to wrongs done 'by deceit, craft or trickery, or at least by means that are dishonest'").
10. Order No. 670, FERC Stats. & Regs. ¶31,202 at P 50 (citing *Dennis*, 384 U.S. at 861).
11. See, e.g., *Powhatan Energy Fund, LLC*, 151 FERC ¶61,179 (2015) (assessing civil penalties and disgorgement of nearly $35 million for allegedly manipulating the market by openly engaging in Up-To Congestion transactions in PJM to collect credit payments that were provided for by the PJM Tariff).
12. Order No. 670, FERC Stats. & Regs. ¶31,202 at P 53 & n.109; see also *Barclays Bank PLC*, 144 FERC ¶61,041 at P 62 (2013) (although "mere negligence" will not suffice "[f]or purposes of establishing a violation [of the Commission's Anti-Manipulation Rule]."
13. See *FERC 2014 Report on Enforcement*, Docket No. AD07-13-008, at 2 (Nov. 20, 2014).
14. See, e.g., *In re Make-Whole Payments*, 144 FERC ¶61,068 (approving settlement involving civil penalties of $285 million and disgorgement of $125 million for alleged market manipulation); *Barclays Bank PLC*, 144 FERC ¶61,041 (assessing civil penalties of $453 million and finding disgorgement of $34.9 million to be appropriate).
15. FERC's investigative procedures have also been the subject of concern by those who believe that it is one-sided and does not comport with basic notions of due process. Among other things, FERC has been criticized for (1) denying parties and their attorneys access to deposition transcripts based on a broad interpretation of what constitutes "good cause" to do so; (2) applying a narrow interpretation of what materials must be turned over under *Brady v. Maryland*, 373 U.S. 83 (1963); and (3) generally denying investigative targets discovery rights with respect to the case being brought against them. See, e.g., Scherman, W. S., Johnson, B. C., & Fleischer, J. J. (2014). The FERC enforcement process: Time for structural due process and substantive reforms, *Energy Law Journal, 35*, 101–149.
16. See, e.g., FERC's Response to Respondents' Memoranda Regarding the Court's Authority to Review De Novo the Commission's Orders Assessing Civil Penalties Against Respondents, *FERC v. Lincoln Paper and Tissue, LLC*, No. 1:13-cv-13056 (D. Mass June 6, 2014), ECF No. 55-1 (arguing that the court can and should merely affirm FERC's penalty assessment without allowing any discovery or trial on the merits based solely on the "administrative record" as defined by FERC).
17. See Lincoln Paper and Tissue, LLC's Memorandum of Law Concerning the Contours of the Trial, *FERC v. Lincoln Paper and Tissue, LLC*, No. 1:13-cv-13056 (D. Mass May 9, 2014), ECF No. 46 (discussing FERC's prior statements regarding the nature of procedures under FPA Section 31(d)(3) and the legal arguments against FERC's current interpretation).
18. See Ibid. at 16–17 (discussing fair notice issues and collecting prior statements).
19. See Sheppard, D., & Bousso, R. (2013, December 5). Deutsche Bank quits commodities under regulatory pressure. *Reuters* ("Sheppard & Bousso"). Retrieved from http://www.reuters.com/article/2013/12/05/deutsche-commodities-idUSL5N0JK3ST20131205 ("[T]he regulatory environment has gotten extremely cumbersome and expensive for banks," and thus "At a number of banks now, you have more people doing compliance and risk management than you have doing the actual trading") (quotations and citations omitted).
20. The risk of FERC seeking disgorgement and large civil penalties—even in cases involving merely reckless conduct—is exacerbated by the risk of collateral civil litigation. See, e.g., *Merced Irrigation Dist. v. Barclays Bank PLC*, No. 1:15-cv-04878 (S.D.N.Y. filed June 23, 2015) (class action mirroring FERC investigation).
21. See Sheppard & Bousso (discussing Deutsche Bank AG's decision to eliminate its energy trading desk in part due to "increased regulatory pressure" following a $1.5 million settlement with FERC and noting similar actions by other banks, including JPMorgan Chase & Co. and Morgan Stanley).
22. See Milch, J., Wittner, S., & Sellito, G. (2015, July 15). Double-digit reductions in U.S. natural gas trading decreases extend multiyear trend of falling trading volumes. *Cornerstone Research*. Retrieved from https://www.cornerstone.com/Publications/Press-Releases/Double-Digit-Reductions-in-US-Natural-Gas-Trading (showing 22% decline in natural gas trading volume based on FERC Form 552 submissions as of May 16, 2015).
23. See Murphy, K. (2004, November). *The role of trust in nurturing compliance*. Canberra, Australia: The Australian National University. Retrieved from https://digitalcollections.anu.edu.au/bitstream/1885/43171/2/49.pdf ("the use of threat and legal coercion as a regulatory tool—in addition to being more expensive to implement—can sometimes be ineffective in gaining compliance" and thus "variables such as trust need to be considered when managing noncompliance").
24. Related positions cases are those involving allegations that a market participant took a position in one market in order to benefit a position in another market. See, e.g., *Energy Transfer Partners, L.P.*, 120 FERC ¶61,086 at P 4 (2007).
25. See *Constellation Energy Commodities Grp., Inc.*, Docket No. IN12-7-000, Statement of Chairman Jon Wellinghoff on the Constellation Energy Commodities Group Investigation (Mar. 15, 2012) (offering guidance to market participants that they should "not trade uneconomically on one position in order to benefit the value of another").
26. See Ledgerwood, S., & Carpenter, P. (2012). A framework for the analysis of market manipulation. *Review of Law and Economics, 8*, 254, 260, 277– 282 (discussing the importance of leverage to any manipulative scheme).
27. Ibid., pp. 287–289 (suggesting potential trading position screening protocols for identifying manipulative conduct but noting that better market transparency is necessary).
28. See *FERC Strategic Plan for FY 2014–FY 2018* at v (emphasis added).