

Eighth Annual Enforcement and Compliance Conference

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or your regular Skadden contact.

John N. Estes III

Washington, D.C. / 202.371.7950
john.estes@skadden.com

John S. Moot

Washington, D.C. / 202.371.7890
john.moot@skadden.com

Mike Naeve

Washington, D.C. / 202.371.7070
mike.naeve@skadden.com

Paul F. Wight

Washington, D.C. / 202.371.7323
paul.wight@skadden.com

Mark D. Young

Washington, D.C. / 202.371.7680
mark.d.young@skadden.com

Donna M. Francescani Byrne

Washington, D.C. / 202.371.7005
donna.byrne@skadden.com

1440 New York Avenue, NW
Washington, D.C. 20005

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Seminar Takeaways

On March 12, 2013, Skadden's Energy Regulation and Litigation Group hosted its Eighth Annual Enforcement and Compliance Conference. The conference brought together representatives from a wide range of market participants, regulators, consultants and lawyers for an informative and spirited discussion of current issues facing the industry.

Keynote Address

The Honorable Tony Clark | Commissioner, Federal Energy Regulatory Commission

Commissioner Clark outlined a principles-based enforcement paradigm, wherein a regulated entity's conduct is guided not only by specific rules, but also by broad principles of appropriate conduct. An enforcement regime that is wholly reliant on specific and detailed rules could have the unintended effect of creating loopholes that could be exploited by market participants. He also discussed the importance of independent market monitors (IMMs) to act as the frontline observers of market conduct and noted that, in several instances, states conditioned an entity's joining an RTO on the existence of an IMM. Commissioner Clark stressed that regulated entities need to establish strong cultures of compliance and to hold accountable those individuals within the organization who engage in improper conduct. Finally, he urged targets of an investigation to be forthcoming with information and stated that the normal role of an attorney to zealously advocate the client's interests in an adversarial judicial context may, in a regulatory context, frustrate efforts to resolve the dispute.

Market Manipulation: When Do Arbitrage and Risk Taking Become Unlawful?

John N. Estes III | Partner, Energy Regulation and Litigation, Skadden
Dr. William W. Hogan | Raymond Plank Professor of Global Energy Policy, JFK School of Government, Harvard University | Senior Consultant, Economic Consulting, FTI Consulting
Dr. Roy J. Shanker | Energy Sector Consultant

The panel discussed the increasing uncertainty with respect to the FERC's definition of market manipulation. Although historically there has been uncertainty because Order No. 670 defined fraud broadly to include actions "impairing ... a well-functioning market," the uncertainty has increased over the last year:

- Consistent with the Commission's 2008 decision in *HQ Energy*, many market participants and counsel believed that it is not market manipulation to engage in actions in one market that are independently profitable (or otherwise are in the entity's own economic interest in that market), even if those actions affect prices in another market. However, recent enforcement actions suggest that this may not be the case.

- In *Deutsche Bank*, the FERC stated that market manipulation could occur “even if these physical transactions had been profitable” and cautioned that stand-alone profitability is only one factor in considering whether conduct constitutes fraud. Consequently, transacting in “related positions” could, in theory, be considered unlawful by the FERC, even if the transactions are economically beneficial on their own merits such that a third party would undertake them.
- The panel discussed the related compliance implications of this uncertainty and expressed concern that it is no longer clear how counsel and compliance officers should advise clients with respect to trading in one market that could affect positions in another. IMMs may be able to provide entities with some guidance, but not all IMMs are willing to do so, and IMM approval does not protect a party from a subsequent FERC investigation.
- The panel also discussed the fact that the successful design of organized electric markets was built, in part, on the necessary interactions between physical and financial products, such as financial transmission rights and virtual trades. Consequently, defining market manipulation too broadly could impair the proper functioning of organized electric markets.

A Look Behind the Scenes of a Major Enforcement Investigation

John N. Estes III, John S. Moot, Paul F. Wight | Partners, Energy Regulation and Litigation, Skadden

Donna M. Francescani Byrne | Counsel, Energy Regulation and Litigation, Skadden

Drawing on their experience in a wide array of public and nonpublic FERC investigations, Skadden attorneys provided their thoughts on the investigative process, potential outcomes and the benefits and drawbacks of various tactics. The following is just a brief summary of those thoughts.

- **Dealing With Staff:** Staff should be treated with respect; they are public servants charged with complex and important tasks. Although sharp substantive differences are to be expected in contentious enforcement matters, these differences should be addressed in a professional manner.
- **Discovery:** Staff may be amenable to narrowing their usually broad initial discovery requests, particularly if it is done without prejudice to the Staff later seeking broader production. In some instances, a target may wish to submit a forensic report detailing the nature of the alleged problem to focus discovery and reduce a target’s concomitant costs. Throughout discovery, it is important to remain cognizant of the risks associated with a perceived lack of candor. Providing false or misleading material to the FERC may result in a separate charge or an increased civil penalty. A target also should request any exculpatory materials that the FERC may have, which often may inform settlement negotiations.
- **Settlement:** Staff typically obtains authority from the Commission for a settlement range. A settlement offer ordinarily is based upon the penalty guidelines and it is often possible to reverse engineer an offer to determine the assumptions that the Staff is using. When making a counteroffer, it is helpful to focus on the merits of the counteroffer rather than the shortcomings of the initial offer. The extent to which the Staff is willing to depart downward from its initial offer varies greatly from case to case.

- **Communicating With the Commissioners:** Although the Commission will fairly consider a target's written submissions, it also can be expected in most cases to provide some deference to the Staff's conclusions. With respect to oral communications, the Commission may waive its stated policy prohibiting oral communications between a target and the Commission, but those exceptions are infrequent. Written submissions should focus on the substantive differences that exist; submissions that attack the Staff's conduct or the integrity of the Staff's positions will not be well received by the Commission.
- **Litigation:** Once a target receives a show cause order, it must elect either an administrative hearing before a FERC administrative law judge or an immediate penalty assessment by the Commission, followed by *de novo* review in a federal district court. If the latter option is chosen, either party has the right to demand a jury trial with respect to liability, but a court may determine the ultimate amount of a civil penalty. As a general rule of thumb, the option of *de novo* review in a federal district court will be the prudent choice for the targets of most investigations.

Reliability Compliance Versus Best Practices: How to Enforce the Former Without Requiring the Latter?

John S. Moot | Partner, Energy Regulation and Litigation, Skadden

Michael A. Bardee | Director, Office of Electric Reliability, Federal Energy Regulatory Commission

Charles A. Berardesco | General Counsel, North American Electric Reliability Corporation

James P. Fama | Vice President, Energy Delivery, Edison Electric Institute

Panel participants discussed some of the compliance challenges created by existing reliability standards and ongoing efforts to streamline the enforcement and compliance program and to improve the standards development process to reduce compliance ambiguities.

- **Standard Development:** The ideal way to address significant ambiguity is prospectively. Input from all stakeholders is important to develop new standards because stakeholders will provide different perspectives. However, large drafting committees can contribute to the development of unclear standards. Going forward, the standard development process would benefit from smaller committees staffed with not only engineers, but also lawyers and auditors.
- **Program Growth and Development:** The panelists discussed how some of the issues associated with reliability enforcement are a natural outgrowth of implementing a new program post-EPAAct 2005 and expanding existing organizations (such as the NERC) to tackle new responsibilities. As the FERC, the NERC and the regions gain experience with compliance and enforcement of the reliability standards, some challenges may begin to decline. For example, there has been a reduction in the number of non-CIP violations (*e.g.*, vegetation management) reported as the industry gains experience with these standards.
- **Enforcement Priorities:** One of the main issues discussed by the panel was how to set enforcement priorities. In this regard, Mr. Bardee indicated that the FERC wants to ensure that the use of its own limited enforcement resources will have a real-world impact on the compliance behavior of the regulated community. Mr.

Berardesco described how the Find, Fix and Track process has been useful in reducing the burdens associated with small violations, but that further work needs to be done and that the Reliability Assurance Initiative (RAI) builds on this initiative by better focusing enforcement and compliance resources on violations that may significantly affect the Bulk Electric System. Mr. Fama described the industry's strong support for the RAI and certain design and implementation issues that may prove important to its success.

Recent Trends in CFTC Enforcement and Compliance

Mark D. Young | Partner, Derivatives Regulation and Litigation, Skadden

Kenneth W. McCracken | Chief Trial Attorney, Division of Enforcement, U.S. Commodity Futures Trading Commission

Erik F. Remmler | Associate Director, Division of Clearing and Risk, U.S. Commodity Futures Trading Commission

The panel provided a brief overview of the CFTC's rules regulating swaps under the Dodd-Frank Act. The CFTC defined swaps broadly and then excluded certain enumerated transactions. Ultimately, however, if a transaction is an unregulated derivative, it is likely now to be a regulated swap, but there is an exclusion for forward contracts that call for physical settlement.

Under new CFTC rules, swaps will be subject to recordkeeping, reporting, clearing and exchange-trading requirements. The current CFTC clearing mandate goes into effect for end-users in September 2013, but the mandate only applies to interest rate swaps and certain credit default swaps. It is expected that clearing mandates for energy swaps will be forthcoming in the future. A commercial end-user may be exempt from the clearing mandate if it (i) uses the swap to hedge or mitigate commercial risk, (ii) is not a financial entity and (iii) has obtained board or committee approval if it is a public entity. A point of concern is whether an energy company's treasury or trading affiliate will be considered a financial entity for purposes of this rule. The CFTC is aware of this issue and has asked its staff to review it and present it with options.

The panel also weighed in on the issue of evasion, describing the facts-and-circumstances test and the role of the legitimate purpose test. While the presence of deception or deceit is not a prerequisite to a finding of evasion, CFTC staff said they would expect it to be present in most cases of evasion.