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Energy Enforcement Alert

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Key Takeaways from FERC Enforcement's Energy Trading Compliance and Market Manipulation Law White Papers

As noted in our November 21, 2016, Client Alert, Federal Energy Regulatory Commission (FERC or the "Commission") Enforcement staff published two white papers—one on energy trading compliance, the other on market manipulation law—along with this year's Annual Report on Enforcement. These white papers are notable not only because of their substance, but because they are the first guidance FERC staff has issued since the Energy Policy Act of 2005 ("EPAct 2005") that addresses (a) how the Anti-Manipulation Rule has been (and, in FERC's view, should be) interpreted and (b) how energy trading companies should design and implement compliance programs to avoid violating the Anti-Manipulation Rule. Below we highlight the key takeaways from these white papers.

Energy Trading Compliance White Paper

FERC has previously addressed compliance issues in a range of contexts. One key document is FERC's 2008 Policy Statement on Compliance, which sets forth general principles for an effective compliance program. This was followed two years later by the 2010 Penalty Guidelines, which also provided general principles and added more detail about what an "effective compliance program" should include to qualify for a reduction in civil penalties. On occasion, FERC has discussed compliance programs in the context of specific enforcement actions, usually when criticizing those programs for their alleged ineffectiveness. Also FERC has discussed compliance programs through settlement agreements (how most enforcement cases are resolved) by requiring improvements to a company's compliance program. But never before—until now—has FERC provided an analysis that goes beyond general principles of effective compliance programs and offers a detailed list and explanation of specific compliance practices that can effectively implement those principles. The white paper is useful for this reason alone: energy companies[1] that are potentially subject to enforcement actions and civil penalties should know what the enforcement agency views as effective compliance measures that, if adopted, may result in reduced penalties or may avoid an enforcement action in the first place.

One other background point is important. FERC writes that "the Commission has consistently emphasized that there is no one-size-fits-all approach to compliance" and that therefore, "the Commission has not mandated or recommended the adoption of any particular compliance program or compliance practices"—so it is "up to individual organizations to choose which, if any, of the effective compliance practices described herein are appropriate for their compliance programs." This means that no company

[1] The white paper is focused on energy trading companies in the context of avoiding market manipulation violations, but, as FERC notes, the compliance practices discussed may also be relevant to avoiding violations of other FERC statutes, regulations, and orders. *See* Energy Trading Compliance White Paper at n.1.

should be penalized (e.g., denied a civil penalty reduction) merely for failure to adopt any specific compliance measures discussed in the paper. However, as a practical matter, energy trading companies would do well to review their existing compliance programs and determine whether the specific measures discussed in the white paper might improve the company's compliance program or, by contrast, can reasonably be rejected as impractical or unnecessary, given the company's size, risk profile, compliance record or other factors. This is because, if a company finds itself being investigated for market manipulation, and FERC staff believes the company should have prevented the conduct, identified it earlier or taken better steps to remedy it, staff will likely ask why the company did not adopt one or more specific compliance measures discussed in the report—not because that measure was "required," but because (in staff's view) the company would have addressed the issue better had it adopted that measure(s). Staff is likely to take this approach because of how this white paper came about: the compliance measures discussed are not hypothetical examples of theoretically beneficial measures, but, rather, actual, examples of specific programs put in place by sophisticated energy companies that, in staff's view, are following good compliance practices that work. Staff learned about these programs by reaching out to energy companies, experts in trading compliance and consulting firms. In short, staff will likely take the view that these measures can, and should, be adopted where appropriate—because, in fact, companies have already done so.

There are many specific measures discussed in this white paper, but, in this alert, we highlight four key takeaways:[2]

First, FERC staff thinks the compliance program should be staffed not just with lawyers, but with employees who have the skillset and experience to understand trading strategies as sophisticated as those the company uses. These should be employees who understand the details of the company's trading book and have the technical knowledge to identify fact patterns that are consistent with market manipulation, and who can understand the explanations company traders are offering for those strategies. Lawyers are essential to understanding and translating the rules of the road, but even the best lawyers often will not fully understand how a trading book works. In practice, FERC itself follows this model. Indeed, FERC (and the CFTC) employs sophisticated analysts (e.g., former traders and economists) who understand how to analyze trading patterns and the relationship between physical and financial positions better than lawyers do—and FERC thinks companies with sophisticated trading books should likewise hire compliance staff who have those skills.

Second, FERC staff thinks compliance training should consist of regular, ongoing, timely, practical lessons—not just formal, annual programs. When there are significant new orders, cases or any other guidance from FERC (or the CFTC), companies should find a way to communicate the key points to

[2] There are several other compliance measures and issues discussed in the white paper that are noteworthy and more controversial (e.g., whether and when to document trading strategies, establishment of internal company positions for financial products, when to record and retain trader communications beyond existing legal requirements). These are important, but our focus in this alert is on the measures that have the most impact in terms of how FERC staff will evaluate the strength of a specific compliance program.

traders and other relevant personnel reasonably quickly. This could be in the form of emails, morning meetings or any other informal way that makes sense in terms of how the company communicates with its employees. The company should keep thorough records of these communications should it ever need to demonstrate its culture of compliance to the government. FERC Enforcement staff is unlikely to find that a company has an effective compliance program if its training consists mostly of formal, annual presentations.

Third, FERC staff thinks regular monitoring and auditing of a trading book is important. This includes such techniques and measures as statistical reviews of position concentrations; reviews of trader activities at locations where traders engage in both physical and financial trading; reviews of profit-and-loss calculations for each product and location combination; and, unique to the electric markets, monitoring for changes in the amount and types of make-whole or out-of-market payments from RTOs. How much, when, where and how to monitor ongoing trading activity is one of the hardest judgment calls a company has to make in terms of what is reasonable and cost-effective. It would be unreasonable for a company that does not do any speculative trading to have to buy costly software or do resource-intensive reviews of trading strategies on a regular basis. Instead, companies should focus their attention on areas where there are risk factors, such as where a company engages in some speculative trading with at least some physical and financial instruments in or around the same or related trading points (especially if they have a sizable market share at those points). Only the company, working with compliance counsel, can make the right judgments about where to focus more expensive monitoring and auditing efforts, given that company’s specific risk profile. Nevertheless, energy trading companies that do anything more than very basic hedging would be well-served to include some form of monitoring and auditing as part of their compliance program.

Fourth, FERC staff emphasizes that companies should not fail to take action when they identify a compliance concern. From FERC staff’s perspective (and other government agencies, too), a company’s failure to follow up on or take appropriate remedial action when it identifies a compliance concern undermines the company’s credibility at the very time it is most needed: when an enforcement inquiry is started or an investigation is opened. Especially risky practices include failing to inquire further when red flags are raised, not addressing the concerns of compliance counsel or other compliance personnel, and not disciplining traders who have engaged in improper conduct. Simply put, the government reacts poorly to a company identifying potential misconduct and not taking steps to address it.

Every company will have to figure out a reasonable, cost-effective approach for implementing these points in a way that makes sense for that particular company. FERC states there is no one-size-fits-all approach—and that is true, largely because every company has a different market presence and different risk factors. So, for example, it would be an unnecessary and inefficient use of resources for a smaller natural gas company that trades primarily to supply customers with gas, or trades solely to hedge price risk, to adopt the same monitoring and surveillance measures of a large, speculative trading firm that takes sizable positions at important trading hubs. Companies should not waste resources by overdoing compliance, just as they should not take compliance shortcuts. However, to reduce risk and establish a compliance program that FERC and other agencies will find to be effective, we think companies should ensure that they adopt some form of these measures, reasonably and appropriately tailored to their specific circumstances.

Anti-Market Manipulation Law White Paper

FERC's Anti-Market Manipulation Law White Paper is now the best single source for determining what the Commission has found to be market manipulation post-EPAct 2005. For regular FERC Enforcement watchers, the key points in this paper are not new: they can be found in a number of FERC staff or Commission documents, especially in Orders to Show Cause or Orders Assessing Civil Penalties (e.g., in *Barclays, Total, City Power* and *Etracom*) and the motion to dismiss and summary judgment-related legal briefs that FERC staff has filed in past and present federal court "de novo review" actions. However, for anyone not immersed in these cases, it is useful to have a single 40-page compendium of FERC Enforcement's current view on market manipulation law.

Three key points arise from this white paper:

First, FERC has been, is and likely will continue to be focused on "related position" (or "cross-product") market manipulation cases. The basic fact pattern of these cases, in both the natural gas and electric markets, is that a trader engages in conduct to affect FERC-jurisdictional physical prices (up or down) to benefit some other position—whether a financial position traded on a CFTC-regulated exchange (a swaps or futures contract), an FTR in an RTO market or a physical position (e.g., the company's generation fleet). The white paper is heavily focused on this kind of conduct, and it is worth noting that, when FERC thinks of market manipulation, this type of conduct is, to a great extent, what it has in mind.

Second, FERC staff remains committed to an open-ended, expansive view of how it will define fraud (and how it thinks federal courts should define fraud in this context). FERC lists "indicia" of fraud, such as the "illicit purpose" of the conduct, whether the trading is "uneconomic" and whether the conduct is "inconsistent with market fundamentals." FERC also lists what it calls "warning signs" of potentially manipulative conduct: "large market shares in price-setting instruments; trading in the physical markets in a direction that benefits a simultaneously held position in a related market; benefiting positions that have exposure to related physical trading; trading large volumes in the physical market without accumulating much of a net position; and physical trading with consistent losses or an indifference to price." However, FERC shows no inclination to provide a more detailed list of prohibited versus legitimate trading conduct. This is likely because FERC staff and the Commission believe that (a) the statutory Anti-Manipulation Rule is intended to be read broadly and generally and not in a manner susceptible to a specific list of prohibited practices; and (b) the statute is intent-based, so conduct that might otherwise be legitimate can be deemed a violation depending on the market participant's ill intent. As a result, unless there is a shift in direction on how to interpret the statute coming from a newly constituted Commission in 2017, market participants will have to continue to depend on the results of individual settlements and individual enforcement actions to determine the specific types of conduct that FERC considers to be prohibited.

This white paper, however, does reveal a new and potentially important avenue for staff guidance: "Entities can also consult with Enforcement staff before engaging in conduct that they understand poses a risk of manipulation" and that "[Enforcement staff] can in most instances at least informally discuss its views, including factors it might consider in determining whether it believes the relevant conduct constitutes manipulation." Traditionally, in our view, this has not been the case—that is, Enforcement staff has not been willing to informally offer guidance about potential conduct, and instead would direct market participants to either consult with RTO/ISO market monitors or use the No Action Letter process (which, especially in the manipulation context, is often impractical and has not been used by market participants).

Third, this white paper arguably includes the most extensive discussion from FERC staff (post-EPAct 2005) on manipulative conduct that it describes as "gaming" of market rules. The Commission itself rarely uses the word "gaming" today—although it did so when describing manipulative schemes by Enron and other market participants before EPAct 2005, as the tariffs at issue in the Western Energy Crisis used the term. However, Enforcement staff uses the word "gaming" frequently (including in this white paper) when describing alleged manipulative schemes in the electric markets. As market participants have pointed out, it is not easy to define gaming in a way that provides clear guidance to the market, but FERC staff offers the following descriptions:

- "behavior that circumvents or takes unfair advantage of market rules or conditions in a deceptive manner that harms the proper functioning of the market and potentially other market participants or consumers"
- "effectively riskless transactions executed for the purpose of receiving a collateral benefit"
- "conduct that is inconsistent or interferes with a market design function"
- "conduct that takes unfair advantage of market rules to the detriment of other market participants and market efficiency."

These are all general concepts and fit within the larger point noted above concerning FERC's broad, expansive view of its Anti-Manipulation Rule. These descriptions and concepts derive from conduct in the Western Energy Crisis, but it is notable that, of the post-EPAct 2005 cases cited in the gaming section of this white paper, there are only two: the 2013 *JP Morgan* settlement and the *Up-To Congestion* cases pending in three different federal courts. With only general concepts based on pre-EPAct 2005 conduct and just two recent matters to analyze, market participants will have to wait to obtain more detailed and workable guidance on what types of conduct the Commission will consider to be gaming under the Anti-Manipulation Rule. One thing is clear from reading the white paper: FERC Enforcement staff is committed to using the rule to investigate, prohibit, and deter gaming conduct, and market participants should assume that Enforcement will continue to move aggressively in this area, unless the Commission decides to change course.

Much of what is discussed in this white paper focuses on what FERC staff or the Commission has said about market manipulation law—not what the federal courts have said. That is because, until recently, substantive federal case law concerning FERC's Anti-Manipulation Rule did not exist. This has now started to change, and will change even more over the next year or so, as federal courts in the "de novo review" cases decide these legal issues in the context of motions to dismiss, motions for summary judgment and at trial.[3] Courts have already decided motions to dismiss in several of these pending cases—in each instance in FERC's favor, by denying defendant's motion and allowing the case to proceed.[4] However, no federal court has yet ruled on the merits of a FERC market manipulation claim. Ultimately, what these courts (at the district court level and on appeal) say about FERC's interpretations of the Anti-Manipulation Rule is what truly matters: the courts do, and should, have the final say. However, until there are more definitive rulings from the courts on these issues, what FERC itself thinks about the Anti-Manipulation Rule is crucial, since FERC's view, until courts say otherwise, guides what investigations it will bring and how the agency will resolve those investigations, whether through closure without action, settlement or litigation.

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3 No federal court has yet decided whether "de novo review" actions are jury or bench trials (though FERC staff and defense counsel have briefed this issue in several cases). If they are bench trials, there will be further development of market manipulation law through findings of fact and conclusions of law. However, whether jury or bench trials, we expect the appellate courts to weigh in on FERC market manipulation law in the coming years.

4 *FERC v. Barclays Bank PLC*, 105 F. Supp. 3d 1121 (E.D. Cal. 2015); *FERC v. Silkman*, 177 F. Supp. 3d 683 (D. Mass. 2016); *FERC v. Maxim Power Corp.*, No. 3:15-cv-30113-MGM, 2016 WL 4126378 (D. Mass. July 21, 2016); *FERC v. City Power Marketing, LLC*, No. 1:15-cv-1428-JDB, 2016 WL 4250233 (D.D.C. Aug. 10, 2016).

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