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Another Court Upholds FERC Theory Of Market 'Gaming'

By **David Applebaum and Todd Brecher** (April 6, 2018, 12:16 PM EDT)

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On March 30, 2018, the U.S. District Court for the Southern District of Ohio issued an order[1] substantially denying the defendants' motion to dismiss the Federal Energy Regulatory Commission's complaint in FERC v. Coaltrain Energy LP, a market manipulation enforcement case where FERC has assessed penalties and disgorgement of approximately $42 million against Coaltrain and certain individual owners and employees.[2]

The case is one of several enforcement actions involving alleged manipulation by energy traders in the PJM market who traded "up-to-congestion" (UTC) financial products for the alleged purpose of collecting out-of-market rebates rather than for the intended purpose of speculating on and arbitraging locational price differences.[3] These types of market "gaming" theories of manipulation — in which FERC does not allege that a market participant violated specific market rules, but rather traded inconsistently with their purpose — have been controversial and viewed as potentially vulnerable in court, at least where the conduct did not also involve some other clear misrepresentation or more obvious fraud. The March 30 order, therefore, is significant, since the court is now the second federal district court in UTC cases to endorse FERC's expansive view of its anti-manipulation authority.[4]

Brief Summary of Facts

The court discusses FERC's factual allegations (which are accepted as true for purposes of a motion to dismiss) at some length, but the essence of the alleged manipulative scheme is as follows: The defendants traded financial (or "virtual") UTC instruments in PJM, which FERC argues are designed to allow market participants to hedge their portfolio or speculate for profit on the difference between prices at two energy trading points — more precisely, on the differences between the "congestion" component of how electricity prices are determined at those "nodal" trading points. When UTC speculators predict price differences, they can make a profit, but their trading can also benefit PJM market participants by adding liquidity to markets and helping to converge market prices, thereby leading to more just and reasonable prices consistent with FERC's core mission.

During the period at issue, the summer of 2010, UTC trades qualified for what is essentially a rebate[5] to users of the PJM transmission system, to the extent UTC traders paid for reservations on the

transmission system. The details of how, why, and in what amounts PJM calculated and distributed these rebates to market participants are not essential to understanding the alleged manipulative scheme. What matters is that UTC traders who paid for transmission would receive a pro rata share of these rebates like all other market participants. What FERC alleges — as it has in the other UTC cases — is that the defendants traded specifically to capture those rebates.

Combining these two points — the purpose of UTC trades and the ability of UTC traders to get rebates — leads to the core of FERC's market manipulation allegation. FERC claims that the defendants knowingly traded UTCs not to find price differences but rather to find locations where there were minimal or no price differences, because the true goal of the trading was not arbitrage (as FERC says it should have been) but rather to get rebates. And FERC alleges that trading UTCs in this way was a manipulative gaming of the PJM market rules, as market participants should only trade UTCs for their intended purpose rather than as a mechanism to collect rebates designed for other market participants engaged in legitimate trading.

The defendants dispute many aspects of the facts and legal issues at the heart of FERC's case and will undoubtedly press those arguments as the case proceeds. But the key point for market participants at this stage is to understand that the court agreed that if FERC could prove these allegations as a matter of fact, the agency's theory of market manipulation is legally valid.

March 30 Order

The most significant aspect of the March 30 order is the court's analysis of FERC's theory of manipulation and the defendants' argument that FERC failed to legally state a manipulation claim because the alleged conduct was not actually fraudulent. The court denied the defendants' argument and largely endorsed FERC's broad view of its anti-manipulation authority. Below we highlight key elements of the court's decision on this issue:

- Fraud is required — but defined broadly and flexibly. The court confirmed that, notwithstanding FERC's broad definition of fraud in the anti-manipulation rule (i.e., any conduct "for the purpose of impairing, obstructing or defeating a well-functioning market"),[6] consistent with securities law precedent there must be some form of deception to sustain a violation. However, invoking U.S. Supreme Court precedent in the securities context, the court found that "[w]hat conduct counts as deceptive" in violation of the Anti-Manipulation Rule "is not to be narrowly construed" — and that the rule should be applied "flexibly and broadly, rather than technically or restrictively."[7]

- A "deceptive purpose" can make otherwise lawful trades fraudulent — and trading inconsistent with the purpose of market rules can be a "deceptive purpose." The court found that FERC sufficiently alleged fraud by claiming that the defendants placed UTC trades with a deceptive purpose (i.e., to collect rebates), instead of price arbitrage, which FERC claimed was the intended purpose of UTC trading.[8] Other courts have similarly concluded (both in FERC cases and elsewhere) that a trader's intent can make otherwise lawful trades manipulative. But this order is significant in that it suggests trading regional transmission organization market instruments for a reason other than FERC's (or the market operator's) intended purpose could be considered deceptive. This effectively tasks market participants with needing to understand not only market rules but also their purpose.

- Differences between securities and energy markets are relevant to manipulation analysis. Relying in part on securities law precedent, the defendants argued that FERC failed to state a claim because it did not allege any actual harm to electricity prices. After concluding that FERC need not necessarily allege actual harm to bring a claim, the court found that the defendants' argument also "obfuscat[ed] the difference between the securities and the electricity markets."[9] The court found that here, irrespective of any effect on electricity prices, the defendants' conduct allegedly affected the use and cost of transmission service since the defendants paid to reserve transmission in connection with their UTC trades and captured rebates that would have gone to other market participants. Because the anti-manipulation rule prohibits fraud "in connection with the purchase or sale of electric energy or the purchaser or sale of transmission services," the court found that FERC sufficiently alleged harm.[10]

- FERC's "well-functioning market" definition of fraud precludes a defense that market participants did not receive fair notice that FERC could find gaming-type conduct unlawful. The anti-manipulation rule's definition of fraud to include all conduct intended to "impair[], obstruct[], or defeat[] a well-functioning market" has been controversial given its breadth, vagueness and, arguably, the lack of a requirement that conduct also be deceptive. While the court, as noted above, found that deception was nevertheless required as a statutory matter, it also found that FERC's "well-functioning market" definition of fraud nevertheless put market participants on notice that any conduct that interfered with a well-functioning market could be deemed manipulative.[11] If followed by other courts, this endorsement of the "well-functioning market" definition for purposes of "fair notice" could make it difficult for market participants to prevail on such a defense.

The March 30 order also addressed several other issues raised in the defendants' motion to dismiss. We highlight some of the more significant ones below:[12]

- "De novo review" debate is essentially resolved. The court agreed with the defendants' argument that the case should not proceed as an "administrative review proceeding," but rather "should proceed like any other civil lawsuit [under] the Federal Rules of Civil Procedure."[13] In reaching this conclusion, the court did not engage in its own detailed analysis of the Federal Power Act's statutory scheme, but simply cited and incorporated the reasoning of the six other district courts that reached the same conclusion.[14] It is unknown as of this writing whether FERC will continue to advocate for an "administrative review" in these types of district court cases going forward, though we think it is doubtful FERC will do so. In any event, with a wide range of district courts in agreement on this issue, it is, for all intents and purposes, a resolved question of law.

- No "aiding and abetting" liability, but being a "primary violator" does not require actual trading. The court confirmed that the anti-manipulation rule does not cover secondary violations such as "aiding and abetting," but rather only "primary violations."[15] However, the court accepted FERC's "scheme theory" of liability, in which a person who did not actually place any allegedly manipulative trades, but participated in decisions to place such trades, could be held liable under a "scheme theory" (i.e., that they participated in the alleged fraudulent scheme). The court made clear that developing, strategizing about, researching, or designing a scheme in and of itself is not a violation. But participating in the execution of such a scheme — even without actually placing the trades — could be a violation.[16]

- Proof of “recklessness” can satisfy the “intent” element of the anti-manipulation rule. Consistent with securities law precedent, scienter (i.e., wrongful intent) is a required element of a violation of the anti-manipulation rule. FERC concluded in the anti-manipulation rule that recklessness can satisfy the scienter requirement, and the court here largely agreed. The March 30 order accepts that at least severe recklessness can constitute scienter under the anti-manipulation rule, noting that under securities precedent, “scienter may be established by proof of recklessness — highly unreasonable conduct which is an extreme departure from the standards of ordinary care.”[17]

- Individuals are not jointly and severally liable for company’s “duty of candor” violations. In addition to finding that Coaltrain and certain individual owners and employees violated the anti-manipulation rule, FERC also found that Coaltrain violated the duty-of-candor requirement, 18 C.F.R. § 35.41(b), by (1) making false and misleading statements regarding the accuracy and completeness of disclosures to enforcement staff during the investigation and (2) omitting material information regarding the existence of certain records. The court rejected the defendants’ substantive challenges to FERC’s § 35.41(b) claim. However, the court agreed that Coaltrain’s individual owners could not be held jointly and severally liable for those violations since FERC did not allege they individually violated the rule (which applies only to “sellers” — generally electric utilities with market-based rate authority — and not individuals).[18] The court did not rule on joint and several liability for violations of the anti-manipulation rule, finding that the debate was premature at the motion to dismiss stage.

Conclusion

As FERC enforcement watchers are aware, the agency has had a string of losses on the “de novo review” issue — and, as noted above, we think that issue has now been resolved in defendants’ favor going forward (and has been for some time). But FERC has also prevailed in every motion to dismiss filed to date, in a range of diverse market manipulation cases. Those motions do not assess who should prevail on the merits, but they do address whether FERC has alleged a legally valid theory of market manipulation. The court in this most recent decision upheld FERC’s theory, and did so expansively. District court decisions such as this can be persuasive, although not binding, authority to other courts, and ultimately the scope of FERC’s anti-manipulation authority will be decided in the appellate courts — but that likely will not happen for some time. Until appellate courts provide such guidance, or there is an express change or clarification of market manipulation enforcement policy at the commission, for compliance purposes, market participants trading physically or financially in FERC-regulated electric (or natural gas) markets should be aware of these court decisions.

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Disclosure: David Applebaum had supervisory responsibility over the investigation discussed in this article while he was at FERC. The order, and the briefing relating to it, occurred after Applebaum left the agency.

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[1] Opinion and Order, FERC v. Coaltrain Energy, L.P., No. 2:16-cv-732 (S.D. Ohio, Mar. 30, 2018) ("March 30 Order").

[2] See Coaltrain Energy, L.P., 155 FERC ¶ 61,204 (2016) (order assessing civil penalties).

[3] See FERC v. Powhatan Energy Fund, LLC, No. 3:15-cv-00452-MHL (pending in the Eastern District of Virginia); FERC v. City Power Mktg., 196 F. Supp. 3d 218 (D.D.C. 2016) ("City Power").

[4] The other decision is City Power, which the court here cites approvingly throughout.

[5] The rebates are called "Marginal Loss Surplus Allocation" payments, but here we will refer to them simply as "rebates."

[6] March 30 Order at 27 (quoting Prohibition of Energy Mkt. Manipulation, Order No. 670, 114 FERC ¶ 61,047, at P 50 (2006)).

[7] Id. at 29 (internal quotations and citations omitted).

[8] Id. at 30.

[9] Id. at 38.

[10] Id.

[11] Id. at 39.

[12] Given our focus here on the market manipulation analysis and related matters, we do not discuss other issues in the decision such as personal jurisdiction, venue, and FERC's authority under the Federal Power Act to regulate virtual transactions.

[13] March 30 Order at 7-8.

[14] Id. at 8.

[15] Id. at 48.

[16] Id. at 48-52.

[17] Id. at 53 (internal quotations and citations omitted).

[18] Id. at 60-72.