CFTC, FERC and Banking Agency Oversight of OTC Energy Markets and Participants: Recent Developments Affecting Financial Institutions

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CFTC Jurisdiction Over Energy Markets

- Commodity Exchange Act (CEA), CFTC rules and Exchange rules govern energy futures and option contracts traded on Designated Contract Markets (DCMs) such as NYMEX.
- Commodity Futures Modernization Act (CFMA) enacted in December 2000 created category of Exempt Commercial Markets (ECMs) such as ICE which are more lightly regulated than DCMs.
- CFMA also created exemptions and exclusions from CFTC jurisdiction for most OTC energy transactions between sophisticated parties, including but not limited to transactions on ECMs.
- Market participants with reportable futures positions or a DCM membership still must comply with CFTC record keeping requirements which include records relating to OTC transactions.
- District courts have held that, even if transactions fall within CFMA exemptions or exclusions, CFTC can sue OTC energy market participants for violations of CEA § 9(a)(2), which prohibits manipulation, attempted manipulation and false reports.

7 U.S.C. § 13(a)(2)

Section 9(a)(2) of CEA makes it unlawful to:

"…manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity or knowingly deliver or cause to be delivered through the mails or … other means of communication false or misleading or knowingly inaccurate reports concerning … market information or conditions that affect the price of any commodity in interstate commerce …."

Penalties for § 9(a)(2) Violations

- Civil monetary penalty: $130,000 or triple the monetary gain for each violation
- Criminal fine: $500,000 for individuals, $1 million for entities
- 5 years imprisonment
- Trading and registration bans, restitution, injunctive relief

Increased penalties under pending CFTC reauthorization bill:

- Civil monetary penalty: $1 million or triple the monetary gain for each violation
- Criminal fine: $1 million (whether entity or individual)
- 10 years imprisonment

Elements of CFTC Manipulation Claim

- Defendant (Δ) had ability to influence market price.
- Δ intended to manipulate market price. (“*Intent is the essence of manipulation.”)*
- “Artificial price” (*i.e.*, doesn’t reflect legitimate supply/demand forces) existed in market.
- Δ caused artificial price.

Elements of CFTC Attempted Manipulation Claim

- Δ intended to create artificial price.
- Δ performed some overt act in furtherance of that intent.
- CFTC need not prove artificial price or causation.

Elements of CFTC "False Reports" Claim

- Δ sent, or caused to be sent, market information across state lines.
- Δ knew the information was false or misleading.
- The information affected or tended to affect commodity price.

Aiding and Abetting Violation of § 9(a)(2)

- If a third party knowingly participated in a violation of § 9(a)(2), and specifically intended to further that violation, then
- The third party is liable for the violation to same extent as principal violator.

"Controlling Person" Liability for § 9(a)(2) Violation

- If third party "controlled" person who violated § 9(a)(2) (*e.g.,* was his direct or indirect manager or supervisor), and
- Knew or should have known about acts that constituted violation and allowed them to continue, and
- Failed to act in "good faith" (*e.g.,* had inadequate system of supervision and control, or didn't enforce company policies), then
- The third party is liable for violation to same extent as the "controlled" person

CFTC v. Diplacido **(2004)**

- Avista Energy and floor broker (Diplacido) charged with manipulating NYMEX electricity futures contracts to profit on OTC options with value at expiry based on NYMEX settlement prices.
- Judge Painter found that Diplacido's conduct (*e.g.,* offering through bids) "had no apparent business or economic rationale except to influence market prices."
- "Unnecessarily high" bids showed "clear intent to create an artificial price."
- "The inference is inescapable that [Diplacido] paid more than he had to … for the purpose of causing the closing price to be at that high level. No further proof is needed to show that the settlement price was artificial. By paying more than he had to, [Diplacido] created an artificially high price."

CFTC Enforcement Actions Against *Energy Transfer Partners* and *Amaranth*

- CFTC alleges that ETP attempted to manipulate price of natural gas in Houston Ship Channel and *Inside FERC* index prices to profit on HSC financial basis swaps.
- CFTC alleges that Amaranth and head trader attempted to manipulate prices of NYMEX natural gas futures contracts "by placing large sell orders during the closing range on expiration day" to profit on financially settled NYMEX look-alike swaps on ICE.
- FERC filed proceedings against ETP and Amaranth based on same alleged conduct.
- Amaranth requested stay of FERC action based on CFTC's exclusive jurisdiction over futures transactions on DCMs.
- Briefs filed by CFTC, FERC and amici curiae.
- Hearing in district court on October 5.

Hearing to Examine Trading on Regulated Exchanges And Exempt Commercial Markets September 18, 2007

- "The proper regulation of the nation's energy markets is one of the most significant issues facing this Commission." *Acting Chairman Walter L. Lukken*
- "The central problem is that the CFMA seems to have placed large swaths of the energy derivatives markets beyond key elements of the CFTC's jurisdiction." *Commissioner Michael V. Dunn*
- "The Amaranth case and the Senate report show clearly how inextricably intertwined off-exchange and on-exchange energy markets are." *Commissioner Bart Chilton*
- "Questions have also been raised about the role of speculation in both marketplaces." *Commissioner Jill Sommers*

S. 2058— "Close the Enron Loophole Act"

Senator Carl Levin

- Would require "Energy Trading Facilities" to:
  - register with the CFTC
  - establish trading limits or "accountability levels"
  - prevent price manipulation
  - prevent excessive speculation
- Would require those making large trades of U.S. Energy commodities from the U.S. on foreign exchanges to report those trades.
- Would extend the coverage of CEA anti-fraud provisions to principal-to-principal transactions.

Proposed Amendment to CFTC Reg. 18.05

- CFTC Reg. 18.05 now requires that a trader holding a reportable position keep books and records on all futures and options as well as cash market positions and other commercial activities that the trader hedges using futures.
- The proposed amendment would extend/clarify the requirement to include all positions and transactions on:
  - Over-the-Counter markets
  - CEA §§ 2(d), 2(g) or 2(h)(1)-(2) excluded or exempt transactions
  - Part 35 exempt swaps
  - Exempt commercial markets
  - Exempt Boards of Trade


DEPARTMENT OF ENERGY
FEDERAL ENERGY REGULATORY COMMISSION

FERC Jurisdiction Over Energy Markets

- Transmission and sale of natural gas for resale in interstate commerce
- Transmission and wholesale of electricity in interstate commerce
- Reliability of the high voltage interstate transmission system
- Monitors and investigates energy markets
- Uses civil penalties and other means against energy organizations and individuals who violate FERC rules in the energy markets
- Physical markets

Major Emphasis on Enforcement

- The Western electricity market crisis
- Manipulation of natural gas and electricity price indices
- Violations of rules governing separation of transmission/transportation functions from marketing functions
- Failures to comply with FERC regulations and requirements
- Stated intention to rigorously enforce laws and regulations

Primary Statutory Sources of Authority

- Natural Gas Act
- Natural Gas Policy Act of 1978
- Federal Power Act
- Energy Policy Act of 2005 – significant amendments to the Natural Gas Act and the Federal Power Act

Energy Policy Act of 2005

- Added Section 4A to the Natural Gas Act

  "It shall be unlawful for any entity, directly or indirectly, to use or employ, in connection with the sale or purchase of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance (as those terms are used in section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) in contravention of such rules and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas ratepayers. Nothing in this section shall be construed to create a private right of action."

Energy Policy Act of 2005 (cont'd)

- Added Section 22 to the Federal Power Act:

"(a) IN GENERAL. – It shall be unlawful for any entity (including any entity described in section 201(f)), directly or indirectly, to use or employ, in connection with the purchase or sale of electric energy or the purchase or sale of transmission services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance (as those terms are used in section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)), in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of electric ratepayers.

"(b) NO PRIVATE RIGHT OF ACTION.—Nothing in this section shall be construed to create a private right of action."

Energy Policy Act of 2005 (cont'd)

- Amended the Natural Gas Act, the Federal Power Act and the Natural Gas Policy Act of 1978 to increase the maximum daily civil penalties from $5,000 to $1,000,000 and to increase criminal penalties.

FERC Implementing Regulations

- 18 C.F.R. §§ 1c.1 and 1c.2
  - Make it unlawful, in connection with FERC-jurisdictional activities in the natural gas and electricity sectors:
    1. To use or employ any device, scheme, or artifice to defraud,
    2. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
    3. To engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity.
- *Scienter* (intent or recklessness) is a necessary element.
- Market Behavior Rules
  - Natural Gas – 18 C.F.R. §§ 284.288 and 284.403
  - Electricity – 18 C.F.R. §§ 35.36 and 35.37

FERC Policy Statement on Enforcement

- Enforcement options:
  - Revocation of market-based rate authority
  - Disgorgement of unjust profits collected in violation of tariff requirements (different and much more expansive authority than ability to modify rates and require refunds)
  - Civil penalties
  - Referral to Department of Justice for criminal investigation

FERC Policy Statement on Enforcement (cont'd)

- Factors considered by FERC:
  - What harm was caused by the violation?
  - Was the violation the result of manipulation, deceit or artifice?
  - Was the action willful or part of a broader scheme?
  - Is this a repeat offense? Does the company have a history of violations?
  - Was the wrongdoing related to actions by senior management?
  - How did the wrongdoing come to light and how did senior management react?
  - What effect would the potential liabilities have on the financial viability of the company that committed the wrongdoing?
  - Does the company have a formal program and culture of compliance, and how did it respond to the wrongdoing?
  - Did the company self-report the problem to FERC and take immediate steps to correct any problem?
  - Did the company cooperate fully with FERC's investigation?

FERC Enforcement Actions

- Refunds in Western electricity market cases
- Imposition of civil penalties and disgorgement for:
  - Failure to comply with open access transmission tariffs
  - Failure to provide information to all customers on a timely, non-discriminatory basis
  - Failure to comply with standards of conduct
  - Failure to seek prior FERC approval for the acquisition of a power marketer
- Significant civil penalties and disgorgements

Amaranth and ETP Show Cause Orders

- Amaranth
  - Show Cause Order alleges that Amaranth manipulated natural gas prices through trading on the NYMEX
  - Amaranth did not engage in physical trading, but Show Cause Order alleges that the manipulated NYMEX settlement price is used to determine the price of FERC-jurisdictional physical trades
  - Show Cause Order seeks civil penalties of $232 million, plus disgorgement of $59 million in unjust profits
  - Critical case in testing (1) the extent of FERC's new powers, and (2) the boundaries between CFTC and FERC jurisdiction
  - Extensive proceedings before FERC, the CFTC and the courts to resolve legal issues of first impression

Amaranth and ETP Show Cause Orders (cont'd)

- ETP
  - Show Cause Order alleges that (1) ETP manipulated wholesale physical gas markets at Houston Ship Channel and Waha, Texas, and (2) ETP intrastate pipeline affiliate discriminated against non-affiliated shippers and charged rates in excess of its maximum lawful rates
  - Show Cause Order seeks civil penalties of $97.5 million and disgorgement of over $70 million in unjust profits
  - Legal challenges, including process and procedure for levying penalties

Amaranth and ETP Show Cause Orders (cont'd)

- Cases are:
  - First fully litigated uses of FERC's new power, as other cases have been settled;
  - Precedent-setting, as the scope of FERC jurisdiction is tested and defined;
  - Source of conflict between the CFTC and FERC (in the Amaranth case); and
  - Likely to increase pressure for legislation

Lessons for FERC-Jurisdictional Activities

- Enforcement is a major priority for FERC.
- Formal programs for internal compliance and ongoing monitoring are essential.
- The lines between sharp practices and impermissible manipulation are still unclear.
- The definition of the threshold between violations versus normal business glitches is very low, but will evolve over time.
- Entities remain subject to potentially conflicting rules and regulations.

Comptroller of the Currency
Administrator of National Banks

The Federal Reserve Board

Role of Banks in Energy Trading Activities

- Banks - - issues of scope of authorized banking powers
- Bank Holding Companies - - issues of what has been approved by the Federal Reserve Board
- Foreign Banks - - operating through branches and subsidiaries

OCC Interpretations of Energy Powers of Banks

- Instantaneous transfer of title
- Cash settled derivatives transactions
- Physically settled transactions not permitted

Bank Holding Companies - - Financial in Nature Activities

- Cash settled derivatives
- Instantaneous Transfer of title
- Energy repos
- Volumetric Transactions
- Merchant banking investments

Financial Holding Companies - - Physical Energy Trading

- Purchase and sell as principal power, natural gas and certain other energy commodities
- Maintain an inventory of energy commodities
- Contract for the transmission of electricity and the transportation and storage of natural gas and other commodities

FRB Conditions on Physical Trading

- Permissible commodities are those for which the CFTC has authorized derivatives contracts for trading on U.S. futures exchanges or that FRB has otherwise approved
- Capital based limits - - inventory of physical commodities may not exceed 5 percent of the financial holding company’s consolidated Tier 1 capital
- May not own, operate or control facilities that process, refine, transport, store or distribute commodities

Emerging Developments?

- Energy management agreements
- Tolling agreements
- FRB approval of additional commodities

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