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Wellinghoff, others ponder manipulation-case law

PJM general counsel compares SEC, FERC missions

FERC's enforcement activity and the backlash against it from some of the probes' targets have generated lots of noise in the press lately, but behind all that is an ongoing legal argument of exactly what "manipulation" is under the law. The commission explicitly modeled its enforcement powers on the Security & Exchange Commission's 10b-5 rules, which generally require fraud to be seen as an element of manipulation, PJM General Counsel Vincent Duane told us in an email last week.

But the missions at SEC and FERC do not match up perfectly because the latter is still a rate regulator under federal law, he added.

"The Energy Policy Act of 2005, the source of FERC's current manipulation-enforcement authority, did not repeal the Federal Power Act requirement that wholesale market outcomes be just and reasonable," Duane said. "And one standard emerging out of the commission in these cases is that the conduct not be a scheme or artifice that impedes or distorts a well-functioning market.

"I would regard this standard as consistent with the commission's larger Federal Power Act responsibilities as a rate regulator."

To the extent reading goes beyond the SEC's rules, it can be justified under FERC's different responsibilities where it has set up markets – but they still have to ensure just and reasonable rates, he added.

Eventually the courts will have a say on the debate and they, or further FERC action, could shake out some of the incongruities in the two statutes, Duane said.

Former FERC Chairman Jon Wellinghoff told us he does not agree with that, arguing that with respect to power and natural gas markets, the commission is "very much a market overseer."

"There is a requirement still in the Federal Power Act to always be just and reasonable but it's been assumed by FERC that if you have markets structured properly, then ultimately the rates that are produced by those markets will in fact be just and reasonable," he added.

Powhatan Energy Fund was accused of manipulating

up-to congestion charges in PJM to get marginal lineloss credits. The firm made its defense very public and one of the major arguments coming from that case was that their conduct was not against the rules.

While others argued before FERC that when its and others' trades first came to light in 2010, they impeded well-functioning markets, the firm won some converts in the office US Sen Robert Casey, D-Pa, to its "not against the rules" argument. The senator recently sent a letter to FERC, released by Powhatan last week, asking whether it ever pursued enforcement actions "against entities that were not acting in violation of then-current applicable laws and regulations."

Order 670 laid out the commission's enforcement authority and in it, FERC defined "fraud" generally to include "any action, transaction or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market." That sentence comes with a footnote citation of the 1966 Supreme Court decision in Dennis v United States.

The old court case covered a group of union officials who lied on some of those "are you now, or have you ever been a member of the Communist Party?" affidavits to get the National Labor Relations Board (NLRB) to oversee them. The defendants argued that they did not commit fraud because the NLRB's governing statute did not explicitly require them to fill out the forms truthfully.

But the Supreme Court decided that argument distorted Congress' intent and thus still constituted fraud.

The concept of fraud has always been legally nebulous by design with regulators such as FERC unable to come up a list of traits that would constitute it since it covers an "infinite variety of cases," FERC Commissioner Tony Clark said in a recent article published by the *Colorado Natural Resources Energy & Environment Law Review.*

"Because there is no single method by which fraud is best detected, manipulation or fraud enforcement is intensely fact specific," Clark said. "And the absence of a list of specific prohibited activities does not lessen the reach of FERC's anti-manipulation rule.

"Nor does it mean that FERC enforcers are making up the rules as they go along."

Litigants on the other side of FERC have argued the commission is stretching its definition of fraud too far, with Skadden Arps Partner John Estes telling us eventually it will be constrained by the courts. "In particular, I think they will lose their efforts to expand the definition of fraud to include any conduct that interferes with a well functioning market – citing the Dennis case – because the case law makes clear that you can't avoid the need to prove fraud in the first place by relying on that argument from Dennis," he added.

The courts could end up ruling that way with some firms challenging commission actions in pending cases, but Wellinghoff believes the commission has not been set back that way yet. "This has been an ongoing debate for a number of years," he added, "but no court has really found yet that what FERC has done has been improper under the Federal Power Act."

The one case where FERC was beat back was in the case of Amaranth trader Brian Hunter, where the commission lost a jurisdictional battle with the CFTC in a "narrow decision," Wellinghoff reminded. That case came up in another high-profile FERC probe against Barclays Bank that is now pending at the courts.

Barclays was alleged to have entered into economically useless physical trades to benefit swaps positions it held. The scheme was somewhat similar to Enron's manipulations during the Western Energy Crisis, Clark said in the law review article.

Barclay's lawyers argued in a court filing that FERC lacked jurisdiction because the trades benefited positions that were under CFTC's domain. FERC responded by posting a letter from the CFTC itself saying that its Enforcement Division probed the conduct as well, but "has decided that the FERC is best situated to pursue Barclays on the present facts" and that it would defer to the energy regulator.

The bank and FERC's lawyers are also doing battle over whether the trades in question constituted fraud under its rules.

FERC's other famous battle with a bank was against JP Morgan, which agreed to a \$410 million settlement to end a probe into its alleged manipulation of Cal-ISO's bid-cost recovery mechanism. That conduct was not explicitly against the rules, with the ISO filed two emergency rule changes at FERC to stop power plants from milking structural inefficiencies in the market created by engineering realities.

Legal gaming still wrong

"If you can find ways to game the market, even if it's not technically against the rules – it's still manipulation," Wellinghoff said.

JP Morgan's settlement did not make it admit to the facts in the case, but Wellinghoff argued that agreeing to pay the largest fine ever in agency history meant their arguments would have likely lost in court.

The allegations against Powhatan are on a much smaller scale than JP Morgan and they center on poor market design, where FERC had changed the rules so that firms who bid up to congestion deals got marginal transmissionloss rebates in one order then had to reverse course a year and half later after the conduct came to light.

But given the complexity inherent in ISO/RTO markets, such poor market rules that can be exploited will continue to pop up.

What makes it just?

PJM does not define market manipulation, which is FERC's role.Transactions that benefit the overall system through price convergence, risk management and liquidity should be encouraged and rewarded, Duane noted.

"But PJM would not consider the extraction of profit arising from inherent and unavoidable structural elements of these complex, highly designed markets, or through the exploitation of design flaws, as a just and reasonable outcomes for other market participants," he added.

Estes is the lawyer for Powhatan trader Houlian Chen and, in a brief to FERC that was released by the firm, he argued that the trades in question were far from manipulative.

"Dr Chen's trades did not violate any law, rule or tariff," Estes wrote.

"They were made openly. There was no fraud, artifice or deceit – no hidden agenda. The trades had economic substance on a stand-alone basis. They did not depend on other trading positions for their profitability."

Powhatan even argued that it was doing the world a favor by highlighting the structural inefficiencies. The firm has cast FERC enforcement as bullies and its principals, the twin brothers Kevin and Richard Gates, set up the "Pufferfish Foundation," named after a "friendly peaceful animal" that "blows up" when threatened or attacked.

WELLINGHOFF: Go to court!

"They can talk about it all they want to, but take it to court and get a court to overturn it," said Wellinghoff. "Like these guys in Pennsylvania that were hammering on Norman Bay. Take it court if you don't think it's right.

"If it's easy to get a court to agree with you then get them to throw it out. Otherwise, shut up. You can talk about it all you want to. Until you get a court to agree with you – it's just talk."

Powhatan cannot take FERC to court until the commission takes action on the probe, at which point that

will be an option for it. The firm's name also would not be publicly attached to the allegations without its current defense.

While the fund's defensive strategy has been noisy, FERC was not able to respond due to its own rules and regulations. That probably was not really bothering Bay and enforcement staff whom he does not believe give "one whit" about the claims, Wellinghoff said.

Powhatan hired Harvard University Professor William Hogan, whose ideas were instrumental in the creation of ISO/RTO markets. His brief for the firm argued that while ISO/RTOs are inherently complex and are going to see times where those complexities can be exploited, firms making money in those ways should not be punished for doing what comes naturally.

Hogan did argue firms should report such inefficiencies.

Penalties should hurt

Another constant feature in markets will be people who believe they are the "smartest guys in the room," who will come up with new schemes for profit, said Wellinghoff. He disagreed with Hogan, noting that, unlike the professor, he cannot be paid by anybody in the markets – having so recently left FERC.

"You got to get the money back if somebody gets it improperly," said Wellinghoff. "You can't say just everybody go out there and take as much as you can and if we find out about it, going forward we'll stop you from doing it again."

If that kind of activity is not followed by enforcement actions, there will be no incentive for people to stop looking for ways to squeeze loopholes for profit, he added.

"You've got to continue to have effective enforcement and oversight, or people aren't going to believe in markets," said Wellinghoff. "If you have people go in there and just rape, pillage and plunder by scheming around the strict letter and wording of the rules, then you might as well go back to economic regulation and forget about markets."