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October 9, 2013

VIA EMAIL

Mr. Steven C. Tabackman
Office of Investigations
Division of Enforcement
Federal Energy Regulatory Commission
888 First Street NE
Washington DC 20426

RE: *Preliminary Findings of Enforcement Staff's Investigation of Up To Congestion Transactions by Dr. Houlian Chen on Behalf of Himself and the Principals of Huntrise Energy Fund LLC and Powhatan Energy Fund, LLC, Docket No. IN10-5-000*

Dear Mr. Tabackman:

We write briefly to outline again why Enforcement should terminate its investigation of Dr. Chen. We also incorporate by reference the arguments made in all prior submissions on behalf of Dr. Chen and Powhatan Energy Fund LLC.[1] The trading activity at issue was consistent with price signals approved by the Commission, added value to the PJM markets and assumed market risks, and contained absolutely no deceptive or fraudulent element.

First, as we have previously explained, Enforcement's case here makes no sense. RTOs often pay market participants a variety of revenue streams. We find it helpful to refer to the various revenue streams in different colors—one thus might speak of red, blue, green, and purple RTO revenue stream dollars. We respectfully submit that if the Commission were to approve an RTO's payment of "purple" dollars, a reviewing court would be unlikely to uphold an order both approving those payments and simultaneously declaring it to be fraud-based manipulation for a market participant to seek to expose itself to receiving them. Why approve the payment streams

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1 *See* Letter from William M. McSwain, Attorney for TFS Capital Principals and Entities, to Steven C. Tabackman, Attorney, FERC (Aug. 24, 2012); Supplemental Submission on Behalf of Dr. Alan Chen (Mar. 16, 2012); Written Submission to Commission Investigation Staff on Behalf of Powhatan Energy Fund LLC (Oct. 21, 2011); Written Submission to Commission Investigation Staff on Behalf of Dr. Houlian Chen (Dec. 13, 2010).

in the first place? And it would be yet another large step removed from reasonable agency action—and a violation of due process—if the Commission were to approve the payment of purple dollars, only to declare—*years later*, after the fact—that it is fraud-based market manipulation for market participants to have sought to earn the purple dollars in the interim.[2] Yet that irrational logic is precisely what Enforcement advocates here.

Second, Dr. Chen's trades were consistent with then-prevailing price signals. The collection and distribution of the transmission loss credits (TLCs) in PJM has been thoroughly litigated, and at the time of the trading activity in question, the Commission had approved PJM's specific method for distributing the loss credits. The Commission understood that "payment of the surplus to arbitrageurs that is unrelated to the transmission costs could distort arbitrage decisions and reduce the value of arbitrage by creating an incentive for arbitrageurs to engage in purchase decisions, not because of price divergence, but simply to increase marginal line loss payments."[3] Nowhere in the Commission's order, however, did it indicate that it would be improper for arbitrageurs to *follow* price incentives designed by PJM and approved by the Commission. Enforcement should not continue to prosecute this "legitimate business decision," which was the result of economically rational behavior, as manipulation.[4] Here, too, "ample record evidence supports that" Dr. Chen's trades were the result of "legitimate business decision[s], resulting from natural market forces, and not alone demonstrative of knowing and intentional or recklessly fraudulent conduct."[5]

To conclude otherwise would fundamentally alter the obligations of market participants. Rather than make decisions consistent with existing price signals, Enforcement's theory of this case expects them to second-guess whether or not certain aspects of the Commission-approved markets are "appropriately" functioning, and then adjust to their behavior accordingly.

Enforcement's position in this case also assumes the conclusion of the dispute at hand: Enforcement contends that "profit from UTC transactions by virtue of arbitraging price differentials in the market required a change in the price spread that is both favorable and greater than the total costs incurred by scheduling the transactions and reserving the associated transmission."[6] But this is an arbitrary and incomplete formulation of profit. Nothing in the Commission's orders indicates that market participants must profit from UTC transactions *only* "by virtue of arbitraging price differentials," or that the transmission loss credits were not a valid source of profits, or even that it was wrong for traders to receive transmission loss credits based on the volume of their trades. In fact, the Commission suggested the opposite. After the

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2 *See infra* n.11 (citing cases).

3 *Black Oak Energy, L.L.C. v. PJM Interconnection, L.L.C.*, 125 FERC ¶ 61,042 at P 43 (2008).

4 *See Blumenthal v. ISO New England Inc.*, 135 FERC ¶ 61,117 at P 42 (2011) (affirming Initial Decision, 132 FERC ¶ 63,017 (2010)).

5 *Id.*

6 Preliminary Findings Letter at 4.

Commission commented that "[i]f arbitrageurs can profit from the volume of their trades, they are not reacting only to perceived price differentials in LMP or congestion, and may make trades that would not be profitable based solely on price differentials alone,"[7] it subsequently approved amendments to PJM's tariff that allocated "surplus marginal line losses to those customers engaging in Up-To Congestion transactions in proportion to the total MWh of those cleared transactions (that paid for transmission services during such hour)."[8] Enforcement now contends that even though the Commission approved the payment of transmission loss credits "in proportion to the total MWh of those cleared transactions"[9]—*i.e.*, based on trade volume—somehow, the Commission "nowhere suggested it would be proper to pay MLSA to those who collected based on volume of trades."[10] This reasoning ignores the Commission's own orders.

Transmission loss credits, along with revenues from the differences between day-ahead and real time energy prices and all of the "total costs incurred by scheduling the transactions and reserving the associated transmission," were components in the profitability of the UTC transactions. To punish Dr. Chen for pursuing a profitable strategy based on an after-the-fact determination that transmission loss credits somehow do not count as legitimate revenues is inconsistent with the Commission's own prior orders, as well as the requirements of fair notice.[11] If this is the expected course of conduct—and if behaving otherwise by simply following market signals is to be found manipulative—then it will deter those voluntary market participants who provide liquidity and price discovery. Enforcement should terminate this investigation because it unfairly requires traders to follow unwritten and arbitrary rules.[12]

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7 *Black Oak Energy, L.L.C. v. PJM Interconnection, L.L.C.*, 122 FERC ¶ 61,208 at P 51 (2008).

8 *Black Oak Energy, L.L.C. v. PJM Interconnection, L.L.C.*, 128 FERC ¶ 61,262 at PP 1, 7 (2009).

9 *Id.*

10 Preliminary Findings Letter at 27.

11 *See Diamond Roofing Co., Inc. v. OSHA*, 528 F.2d 645, 649 (5th Cir. 1976) (explaining that a regulated entity—in this case, an employer—"is entitled to fair notice in dealing with [its] government," and that "statutes and regulations which allow monetary penalties against those who violate them . . . must give . . . fair warning of the conduct" that is "prohibit[ed] or require[d]"); *see also Trinity Broadcasting of Fla., Inc. v. FCC*, 211 F.3d 618, 619, 628-32 (D.C. Cir. 2000) (discussing fair notice doctrine and finding "neither the regulation nor the Commission's related statements gave fair notice" of a requirement sufficient "to justify punishing someone for violating it"); *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1328-29 (D.C. Cir. 1995) (explaining that "when sanctions are drastic . . . 'elementary fairness compels clarity' in the statements and regulations setting forth the actions with which the agency expects the public to comply") (quoting *Radio Athens, Inc. v. FCC*, 401 F.2d 398, 404 (D.C. Cir. 1968); *id.* (citing cases); *In re: Hunter*, 137 FERC ¶ 61,146 at P 72 (2011) ("Due process requires that an agency provide adequate notice of the substance of a rule before penalizing a private party for violating that rule."), *rev'd on other grounds*, *Hunter v. FERC*, 711 F.3d 155 (D.C. Cir. 2013); *cf. FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 509 (2009) (noting that FCC did not seek a penalty where a change in policy had occurred, preventing the subject from having "requisite notice to justify a penalty") (citation omitted).

12 For an additional instance of Enforcement presuming a rule that never was in place, *see, e.g.*, Preliminary Findings Letter at 21 (characterizing Dr. Chen's trades as "sham" because their "profits derived not from

Third, contrary to Enforcement's preliminary findings, Dr. Chen's trades added value to the PJM markets. They contributed to price discovery[13] and, to the extent they caused day-ahead prices to move closer to real-time prices, they promoted market efficiency.[14] They cannot be considered "wash" transactions because they made money and because there was always a non-zero risk that Dr. Chen would be exposed to real time price spread changes.[15]

Enforcement contends that Dr. Chen's trades assumed no market risks because the matched trades did not "attempt[] to profit from spread changes between the DAM and RTM."[16] Enforcement also cites to the fact that Dr. Chen did not transact matched trades "before the [TLCs were] available to him" and that "[t]he number of trades and MWh volumes increased by magnitudes."[17] Enforcement asserts that the matched trades "were designed to circumvent . . . market risk."[18] This view is mistaken.

As we have explained, Dr. Chen's strategy assumed market risk, and it was a calculated risk designed to profit in certain conditions. After Dr. Chen experienced significant losses with a non-matched pair strategy, he sought to reduce the risk of further additional losses by placing trades that left him open to a contingent price exposure. Dr. Chen had reason to believe that the paired trades could break at the bid price of $35/MWh because they had done so in the past. For example, the paired trades involving COMED, COOK, DAYTON, and ROCKPORT had all broken before when the bid price was $35/MWh.

Enforcement treats historical fact as if it were the rule. But the fact that the conditions necessary for Dr. Chen's high-profit scenario did not occur during a locked-in period does not negate the fact they *could* have occurred. The pursuit of a "black swan"-type payout does not make a strategy illegitimate or manipulative.[21] Dr. Chen's matched-pairs trades essentially used the transmission loss credits to reduce or eliminate the cost of taking an out-of-the money option.

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changes in market prices but from taking advantage of the [TLC]"). Throughout the Preliminary Findings Letter, Enforcement assumes there was some rule that the TLC was not a valid source of profits.

[13] Written Submission to Commission Investigative Staff On Behalf of Dr. Houlian Chen, Docket No. IN10-5-000, Appendix A (Affidavit of Dr. Craig Pirrong) at ¶ 23 (Dec. 13, 2010).

[14] *See, e.g., PJM Interconnection, L.L.C.*, 116 FERC ¶ 61,088 at P 18 & n.9 (2006) ("We have found, for example, that virtual trading activities help promote price convergence between the Day Ahead and Real Time Markets and provide other system benefits.") (citing and quoting *ISO New England, Inc.*, 113 FERC ¶ 61,055 at P 30 (2005) ("Arbitrageurs provide important benefits to bid-based markets by helping to ensure that Day-Ahead and Real-Time prices do not diverge significantly, as well as by providing price discovery and liquidity to the market.")).

[15] Pirrong Aff. at ¶¶ 25, 27-33.

[16] Preliminary Findings Letter at 22.

[17] *Id.* at 22-23.

[18] *Id.* at 23.

[21] *See generally* Nassim Nicholas Taleb, *The Black Swan* (2007).

The trades were "low risk, low reward with high reward potential."[22] The transmission loss credit "sometimes . . . cover[ed] the total cost, and also over the total cost," of this strategy, and on other days, it was "not enough to cover the total cost, but it [did] offset part of the charges."[23]

Nor was Dr. Chen's risk limited "only to the extent that something could go wrong in execution of his scheme."[24] To the contrary, one purpose of the limited-risk strategy was to capture the times when a rejected bid resulted in a significant payment on the difference between day-ahead market and real-time market prices. Enforcement errs in asserting that "even if the import leg did not clear, the export leg was no more likely to profit wildly than to lose markedly."[25] As Dr. Chen has explained, "If you choose [the paired trades] carefully, the potential of making money is much higher than the potential of losing money."[26] In fact, after his July 2011 deposition, when Enforcement first raised this claim, we pointed out that Enforcement had never asked Dr. Chen whether there was an asymmetric risk of profitability in his trades, with a greater likelihood of success than failure, and that if they had, he would have explained why the answer is yes.[27] Dr. Chen selected matched pairs where he believed there was a higher potential for the rejected leg to result in a profit.[28]

Enforcement also ignores the risk involved in the transmission loss payments. These were not, as Enforcement presumes, guaranteed rebates based on volume trading alone.[29] As Dr. Pirrong explains, the payments had positive standard deviations in June 2010 through August 2010, "indicat[ing] that the transactions that [Dr.] Chen undertook were risky."[30] On some

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22 Deposition of Houlian Chen at 51:5 (Oct. 7, 2010).

23 *Id.* at 55:19-23.

24 Preliminary Findings Letter at 24.

25 *Id.*

26 Deposition of Houlian Chen at 55:4-5 (Oct. 7, 2010).

27 Based on the Preliminary Findings Letter and Enforcement's inclusion of Dr. Chen's non-matched trades (the "AB-BC"-type trades) in its findings, it appears Enforcement would not be persuaded even if it understood that Dr. Chen's matched trades were designed to profit.

28 Moreover, even if all of Dr. Chen's bids had cleared, that does not mean that his strategy had no "out-of-the-money option" objective. *See Blumenthal*, 135 FERC ¶ 61,117 at P 43; *see also id.* ("Complainants' own witness conceded that ISO-NE could require capacity-backed energy at $999/MWh under certain conditions, and that the capacity-backed energy then would have value at that price. That these circumstances did not arise due to New England's excess capacity market does not alter the potential value of Respondents' offers for reliability purposes.").

29 Preliminary Findings Letter at 2-3, 25.

30 Pirrong Aff. ¶ 47.

occasions, the transmission loss credit could even be negative, resulting in a charge: for example, on October 11, 2011, the credit was -\$0.85/MWh.[31]

In addition, Enforcement overstates the relevance of geographic proximity between node pairs. Enforcement contends that the proximity meant that Mt. Storm and Greenland Gap, for example, "each had similar price movements and therefore similar congestion price spread changes against the MISO interface. The DAM-RTM spread change of the Mt. Storm-to-MISO export would be approximately equal in amount but simply the negative of the DAM-RTM spread change of the MISO-to-Greenland Gap import. . . . The settlement of the two UTC transactions in each export/import pair would reliably net to a de minimis amount of gain or loss."[32] This is incorrect. While these nodes were geographically proximate, they could still be electrically distinct and trades at these nodes could result in material gain. For example, in July 2008, a UTC bid price of \$50/MWh would have resulted in profits of \$42.809/MWh (\$21.891/MWh from MISO-Greenland Gap and \$20.918/MWh from Mt. Storm-MISO). Similarly, the Miami Fort 7 and East Bend nodes, while geographically proximate, would have profited with \$50/MWh bids approximately \$0.413/MWh for the month of March 2009 (\$2.808 from MISO-Miami Fort 7 and -\$2.395 from East Bend-MISO).

Fourth, despite Enforcement's attempts to analogize this conduct to that of Mr. Amanat in *Amanat v. SEC*,[33] there was no deceptive or fraudulent element to any of Dr. Chen's conduct. Enforcement contends that "[l]ike Amanat, [Dr.] Chen sought a credit that was paid based on the volumes of his eligible MWhs, and his receipt of the same decreased the pro-rata share of the money that others would have earned. Additionally, both Amanat's and [Dr.] Chen's trades injected false information into the market because neither conduct was motivated by or aimed to capture price differentials."[34] But this oversimplifies things. Among other things, in *Amanat*, the Third Circuit in an unpublished opinion affirmed the SEC's findings "under the deferential substantial evidence standard of review," but indicated that "[w]ere [it] permitted to conduct a *de novo* review of the record, [it] might well reach a different conclusion with respect to certain of the [SEC's] findings."[35] Enforcement's findings will not receive the same deferential standard of review.[36] Furthermore, in Mr. Amanat's case, there was no analogous SEC order indicating that

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[31] PJM MIC Markets Report at 25 (Dec. 13, 2011), *available at* http://www.pjm.com/~/media/committees-groups/committees/mic/20111213/20111213-item-15-mic-markets-report.ashx. Although the PJM Tariff was altered to adjust who could receive TLCs in September 2010, that change would not have prevented the sign of the TLCs from being negative. It was possible during the time that Dr. Chen traded that TLCs assigned to his trades also could have been negative given the right system conditions.

[32] Preliminary Findings Letter at 9.

[33] 2008 WL 7239890 (3d Cir. 2008) (Unpublished Opinion).

[34] Preliminary Findings Letter at 25-26.

[35] *Amanat*, 2008 WL 7239890, at *2.

[36] 16 U.S.C. § 823b(d)(3)(B) (2012) ("The court shall have authority to review de novo the law and the facts involved" in a federal district court action by the Commission to enforce a civil penalty assessment order.).

the targeting the NASDAQ rebate was the predictable result of Commission-approved incentives. In addition, as counsel for Powhatan has previously explained, unlike Dr. Chen, Mr. Amanat acted with scienter because his individual transactions had no legitimate economic purpose: none of them made money or were intended to make money on a trade-by-trade basis.[37] Dr. Chen's trades, in contrast, were a transparent response to Commission-approved price signals, and each trade sought to make money. They imparted no fraudulent or false information: each UTC bid was made openly and communicated information about Dr. Chen's expectations of the PJM markets. Nor was the determination of transmission loss credits simply based on the volumes of trades; it instead depended on a variety of market factors. Finally, the decrease in the pro-rata share of transmission loss credits is irrelevant to the analysis here because even the Commission acknowledged that no entity is entitled to receive them.

Fifth, we note that Enforcement focuses on several issues that are not relevant to the analysis of whether it should continue its investigation and pursue findings of violations. Dr. Chen's original up-to congestion strategy is irrelevant because PJM changed the rules in September 2009. The frequency of the paired trades' profitability[38] does not indicate that a strategy is manipulative; as we explained earlier, Dr. Chen's strategy was intended to profit from possibly rare, but high-reward circumstances. Expert testimony and Dr. Chen's own testimony demonstrates that the strategy was risky. And the fact that Dr. Chen sought to reduce the spread risk[39] does not mean that Dr. Chen either eliminated that risk or eliminated the significant up-side of his position.

Finally, we disagree with many of Enforcement's characterizations of the evidentiary record. With respect to testimony from Dr. Chen's depositions, Enforcement has made it cumbersome to identify quotes by failing to include citations. But as an example, Enforcement characterizes Dr. Chen's *initial* strategy as one that "could be relied upon to produce a low but consistent positive return over time"[42] and then asserts that Dr. Chen "regarded this strategy as a 'low risk, low reward with high reward potential.'"[43] At that point in his testimony, however, Dr. Chen was discussing the "paired" trading strategy where the rejection of one leg would have provided a substantial payout: after he testified he "tend[ed] to put on low risk, low reward with high potential" trades, he explained that with his strategy, "[i]f you're losing money, you could lose cents or tenths of cents. If you're making money, you are also making cents or tenths of cents, *but you also have a big potential of high reward.* When one of the leg is rejected, the other leg could get you a windfall of money. So that's the kind of potential, high-reward

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37 *In re: Ofirfan Mohammed Amanat*, Release No. 34-54708, 89 S.E.C. Docket 672, 2006 WL 3199181, at *9 (2006) ("Amanat has not disputed that his wash and matched trades involved no change in beneficial ownership.").

38 *See* Preliminary Findings Letter at 9 n.9.

39 *See, e.g.*, *id.* at 8.

42 Preliminary Findings Letter at 7.

43 *Id.*

potential."[44] Not only has Enforcement failed to consider the important factual context of Dr. Chen's testimony, but it has repeatedly ignored Dr. Chen's explanation as to why his "paired" strategy exposed him to an increased likelihood of significant profits.

For the foregoing reasons, we respectfully submit that Enforcement should terminate its investigation of Dr. Chen with a finding of no violations.

Respectfully,

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44 Deposition of Houlian Chen at 51:4-5, 11-17 (Oct. 7, 2010) (emphasis added).