UNITED STATES OF AMERICA

BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

Houlian Chen	)	
Powhatan Energy Fund, LLC	)	Docket No. IN15-3-000
HEEP Fund, LLC	)	
CU Fund, Inc.	)	

POWHATAN ENERGY FUND LLC'S RESPONSE IN OPPOSITION TO ORDER TO SHOW CAUSE AND NOTICE OF PROPOSED PENALTY

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I. INTRODUCTION

This is no ordinary investigation. It has already received an enormous amount of attention – from the Office of Enforcement ("OE"), the media, the public, even Congress and the Inspector General of the Department of Energy. Everybody in the industry knows about this investigation and is watching it. They all want to know what the Commission will do.

The Commission has an opportunity here to demonstrate true leadership. An opportunity to make a decision based on the right reasons – like fidelity to the law and fundamental fairness to market participants – instead of the wrong ones, like deference to OE Staff just because the Staff has consumed over four years on its Up-to-Congestion (UTC) investigation and wants the Commission to validate the Staff's wasting of valuable agency resources and ratepayer funding on this investigation.

The OE Staff Report and Recommendation ("Report") is a pile of nonsense. The Staff has done a disservice to the Commission by throwing this nonsense in the Commission's lap and basically saying – here, you deal with it. The arguments in the Report are so off-base, so easily rebutted, that they show that the Staff simply cannot be reasoned with here. Communicating with the Staff in this matter – even communicating with the former Director of Enforcement himself, now-Commissioner Norman Bay – has been akin to beating one's head against the wall.

The Staff has refused to give any ground on even the simplest, most irrefutable points, if they think giving any ground might signal weakness or otherwise harm the Staff's case. The Staff has never given any meaningful consideration to the numerous arguments advanced by counsel or by the *twelve* independent experts[1] who think that Powhatan and Dr. Alan Chen have done nothing wrong.

Why has the Staff behaved in this manner? Presumably, because they think they can do so with impunity. They know that most defendants in most investigations will just roll over and settle prior to an order to show cause, so that the Staff does not have to prove anything (which is what happened with Oceanside Power in this UTC investigation). And for those that don't initially roll over, the Staff figures that the Commission will have the Staff's back and issue a whopping penalty assessment, at which point the pressure will be too great for defendants to bear. Here, the Staff wants to hold Powhatan responsible for civil penalties of nearly $19 million, which is wildly disproportionate to Powhatan's alleged fraudulent profits of less than $3.5 million and bears no relation to any supposed harm.

Powhatan, however, believes in the integrity of the Commission and the critical gate-keeping role that it plays. Powhatan and its principals have never, ever believed that they have

[1] **Susan J. Court**, Principal, SJC Energy Consultants, LLC, and former Director of Enforcement at FERC; **Jeffrey H. Harris**, Ph.D., Gary Cohn Goldman Sachs Endowed Chair in Finance at the Kogod School of Business, American University, and former Chief Economist at the CFTC; **Larry Harris**, Ph.D., Fred V. Keenan Chair in Finance, University of Southern California Marshall School of Business, and former Chief Economist at the SEC; **Terrence Hendershott**, Ph.D., Cheryl and Christian Valentine Chair, Haas School of Business, University of California at Berkeley; **William W. Hogan**, Ph.D., Raymond J. Plank Professor of Global Energy Policy, John F. Kennedy School of Government, Harvard University; **David Hunger**, Ph.D., Vice President, Charles River Associates International, Inc., and former Senior Economist at FERC; **Stewart Mayhew**, Ph.D., Principal, Cornerstone Research, and former Deputy Chief Economist at the SEC; **Craig Pirrong**, Ph.D., Professor of Finance and Director of the Global Energy Management Institute at the Bauer College of Business of the University of Houston; **Roy Shanker**, Ph.D., independent energy consultant with over 40 years of experience in PJM markets; **Chester S. Spatt**, Ph.D., Pamela R. and Kenneth B. Dunn Professor of Finance, Tepper School of Business, Carnegie Mellon University, and former Chief Economist at the SEC; **Richard D. Tabors**, Ph.D., former Vice President, Charles River Associates International, Inc. and current Principal, Across the Charles; and **Richard G. Wallace**, former Vice President and Chief Counsel for FINRA's Market Regulation Department and former partner at Foley & Lardner LLP.

done anything wrong – let alone anything illegal or fraudulent – and now all they want is a fair shake, an unbiased evaluation of their arguments.[2] After enduring over four years of frustration, they trust that time has finally come.

II. ARGUMENT

At the heart of this case is the relevant PJM tariff language that provided for transmission loss credits (referred to interchangeably as "TLCs," "credits," "MLSA," or "rebates") to be paid to anyone who incurred transmission costs. *See* PJM Open Access Transmission Tariff § 5.5 (Third Revised Sheet No. 399C). And because those credits were distributed *automatically* to all purchasers of transmission in PJM, the transmission loss credits were part of the overall pricing incentive for Dr. Chen (and other traders) to consider when entering into UTC trades.

Responding rationally to that pricing incentive, Dr. Chen (with Powhatan's support) made trades in the summer of 2010 that took the rebates fully into account. He put on trades that he otherwise would not have made, absent the rebates. And he made money on most (but certainly not all) of those trades, once the rebates were included. The Staff characterizes such trading as inherently fraudulent because it was supposedly different from what PJM expected the traders to do – in other words, Dr. Chen was exploiting a "loophole." Report at 21, 27, 31-32, 77.

[2] In addition to the arguments specifically advanced in this Response, Powhatan also hereby incorporates by reference the arguments and materials in its previous submissions, as well as the arguments and materials in Dr. Chen's previous submissions and in his Response to the order to show cause. *See* Written Submission to Comm'n Investigation Staff on Behalf of Powhatan Energy Fund LLC, dated Oct. 21, 2011; Letter from William M. McSwain to Steven C. Tabackman, dated Aug. 24, 2012; Letter from William M. McSwain to Steven C. Tabackman, dated Sept. 24, 2014; Written Submission to Comm'n Investigation Staff on Behalf of Dr. Houlian Chen, dated Dec. 13, 2010; Supp. Submission on Behalf of Dr. Alan Chen, dated Mar. 16, 2012; Letter from John N. Estes III to Steven C. Tabackman, dated Oct. 9, 2013; Letter from John N. Estes III to Steven C. Tabackman and Samuel G. Backfield, dated Sept. 24, 2014.

Maybe he was and maybe he wasn't. Dr. Chen might say that he wasn't exploiting a loophole because such trading was so obviously foreseeable from the tariff itself. Loopholes tend to be things that are not immediately obvious. But for the sake of argument, let's go with the Staff's view in the Report and assume that the trading exploited a loophole. That begs the question: so what? One can never be guilty of market manipulation simply by taking advantage of a flawed market design, or a "loophole." And even if we lived in some strange world in which exploiting a loophole could, by itself, be considered market manipulation, such an allegation could never survive due process scrutiny where, as here, the existing market rules affirmatively anticipated that traders would pursue the rebates. These arguments are explored more fully below.

A. There Is Nothing Inherently Fraudulent About Taking Advantage Of A Market Inefficiency Or "Loophole."

Much of the Report reads like a supposed "gotcha" narrative in which the Staff pats itself on the back for cobbling together various snippets from emails and testimony, usually involving Dr. Alan Chen and Kevin Gates of Powhatan. The problem with this narrative, however, is that every single thing that Dr. Chen and Mr. Gates (or anybody else at Powhatan) has ever said or done before or during the investigation is perfectly consistent with their belief that they did absolutely nothing wrong. The Staff seems to have little understanding of what traders do, how markets work or the relevant law. The only thing the "gotcha" narrative demonstrates is the Staff's own confusion. For example, the Report repeatedly treats "loophole" like the ultimate "gotcha" word: if Kevin Gates ever discussed taking advantage of a "loophole," then he must be admitting to fraud. That is downright ridiculous.

First, as a matter of common sense, there is no illegal connotation to the word "loophole." To the contrary, there is an assumption of *legality*. Indeed, "[t]aking advantage of loopholes in

laws is a time-honored American tradition. It is not a deceitful or unfair means to an end." *Buffalo S. R.R. Inc. v. Vill. of Croton-on Hudson*, 434 F. Supp. 2d 241, 254 (S.D.N.Y. 2006). Congress therefore talks of closing loopholes, not prosecuting them. The working assumption is that where a loophole exists, certain people are taking advantage of it and making money and perhaps the law should be changed to stop those people from profiting. Nobody (except, evidently, the Staff) ever pretends that there's fraud just because somebody is taking advantage of a loophole. *E.g., Macon Cnty. Ill. v. Merscorp*, 742 F.3d 711, 714 (7th Cir. 2014) ("If Macon County is right, a taxpayer who takes lawful advantage of a loophole in the Internal Revenue Code has been unjustly enriched and must disgorge his tax savings. No one believes that.").

Second, finding and exploiting market inefficiencies (or loopholes) is what traders do. They look to maximize profits within the existing rules, even if those rules are flawed. When Dr. Chen saw an opportunity to make money in the summer of 2010, he naturally wanted to make as much as he could, within the bounds of the existing PJM tariff and Commission orders. Arguably, he even had a fiduciary duty to Powhatan to try to maximize the profits he could make from the rebates. *See, e.g.*, Sworn Statement of Larry Harris, at 6 ("Chen had no responsibility to arrange his trades to maximize MLSA payments made to others or to minimize MLSA payments made to him and his clients. In fact, he had a fiduciary duty to his clients to fully consider the MLSA payments when placing his trades."); Sworn Statement of Chester S. Spatt, at 8-9 ("Arguably, Dr. Chen, the agent who was acting as an advisor, would not be fulfilling his fiduciary duty to his clients if he were to leave money 'on the table' and not undertake lawful strategies that he had identified within the context of investments permitted in the fund.").

Similarly, Kevin Gates wanted to maximize profits: there is nothing wrong with wanting to "scale up and try[ing] to become rich." Report at 16. This is America. And there is nothing

wrong with this even if the person exploiting the loophole may think that the market would probably be better off as a whole without the existence of the loophole. *See* Report at 21, 28, 75, 77.

Traders do not make the rules; they merely follow them. They obviously have no obligation to forego profit opportunities just because the rule makers promulgated some rules that arguably should be changed. *E.g.*, *Buffalo S. R.R. Inc.*, 434 F. Supp. 2d at 254 ("Taking advantage of loopholes in laws is a time-honored American tradition. It is not a deceitful or unfair means to an end. And (once again), the Village's remedy lies in a venue other than this Court: it can call Senators Schumer and Clinton and Representative Kelley, and urge them to support an amendment to the ICCTA to correct any manifest injustice that is being worked by the law's loose language."); *see also* Sworn Statement of Susan J. Court, at 6 ("[W]hose fault is it that there was a situation to take advantage of? Dr. Chen? His clients? His clients' investors? As there is no claim that any of them urged or was responsible for crafting the relevant tariff provision, the answer seemed clear, the fault lay with those who had structured the tariff.").

If anything, traders who aggressively exploit loopholes do both the market and the rule makers a service by highlighting the inefficiency of the rules, thereby leading the rule makers to fix whatever problem may exist. *See, e.g.*, Sworn Statement of David Hunger, at 5 ("Trading activities by virtual bidders such as Dr. Chen often expose flawed market rules that can in turn be changed through a tariff filing by the RTO under section 205 of the Federal Power Act (FPA) or by a complaint issued by the Commission or a market participant under section 206 of the FPA. In this sense, the virtual bidders or financial traders serve as the canary in the coal mine, testing the RTO market rules that have been approved by FERC."). That is evidently what happened here, when PJM changed the tariff in September 2010. *See* Report at 31-32.

Third, congressional testimony by the Acting Director of the Office of Enforcement in 2009, Anna Cochrane, confirms that there is nothing inherently fraudulent about exploiting a loophole. In response to questions from Senator James E. Risch of Idaho about market manipulation, Ms. Cochrane explained that "if the trader is tak[ing] advantage of a market rule or a market loophole then we don't have authority to go after them." *Energy Market Transparency and Regulation: Hearing Before the Subcomm. on Energy of the Comm. on Energy and Nat'l Res.*, 111th Cong. 25 (2009) (statement of Anna Cochrane, Acting Dir., Office of Enforcement, Fed. Energy Regulatory Comm'n), attached as Exhibit A. Acting Director Cochrane made her statement a year before the trades at issue here. There is no authority *anywhere* that contradicts her statement (and the Staff obviously points to none in its Report). As long as the trader follows the existing rules, he or she can exploit the loophole in the most aggressive – indeed, the most spectacular – fashion imaginable and not run afoul of the law. In short, the idea that Powhatan broke the law (or has anything to apologize for at all) just because it may have aggressively exploited a loophole is absurd.

It is true that following the rules includes conducting trades in an honest manner. All of Dr. Chen's trades met this standard: he accurately entered the information necessary to conduct the trades, which were carried out openly. He did not attempt to hide, conceal or misrepresent anything to PJM or to the market participants. He did not make false or misleading representations. Even the Staff recognizes this – although, predictably, it makes no difference to them. *See* Report at 50 (admitting that the trades "did not involve any false statements, active concealment, or other explicit tariff violations").

The bottom line is that the Staff, as well as PJM, simply does not like the trading at issue because it was too bold, too opportunistic, too profitable and, most importantly, too embarrassing

because it exposed the loophole in the system. According to the Report, PJM supposedly "worked assiduously if unsuccessfully to craft an MLSA distribution mechanism" that would have prevented trades like Dr. Chen's. Report at 70. That the trades embarrassed PJM and laid bare its "unsuccessful" efforts does not make the trading illegal. Smart traders exist to expose loopholes and to be bold, opportunistic and profitable. Now, in order to save face, PJM and the Staff want to manufacture a way to punish Dr. Chen and Powhatan and have settled upon the idea that they engaged in market manipulation. There was no market manipulation here. But what is even more obvious is that any allegation of market manipulation could never survive due process scrutiny. That is the most compelling reason why the Commission should prevent this case from proceeding any further.

B. Proceeding With This Case Would Be Unconstitutional Because Powhatan Never Received Prior Notice That The Trades At Issue Were Unlawful.

The Due Process Clause of the Fourteenth Amendment requires that "laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited." *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972). Due process "incorporates notions of fair notice or warning" and "requires legislatures to set reasonably clear guidelines for law enforcement officials and triers of fact in order to prevent 'arbitrary and discriminatory enforcement.'" *Smith v. Goguen*, 415 U.S. 566, 572-73 (1974) (citations omitted). As discussed below, Powhatan was never put on notice prior to or during the relevant period at issue that Dr. Chen's trades were prohibited.

1. *The Relevant Commission Orders Predicted That Traders Would Pursue Trades That Were Profitable Only After Including The Rebates And Never Stated That There Were Legal Problems With Such Trading.*

No PJM tariff provision and no Commission order ever alerted Powhatan that the trading at issue could be unlawful. Moreover, the tariff language relating to the rebates expressly

provided for them to be paid to anyone who incurred the transmission costs and other fixed costs of the PJM system, without any other limitation.

When it first addressed the allocation of TLCs in the *Black Oak Energy* proceedings, the Commission recognized the incentives that the credits would provide to virtual traders:

> Paying excess loss charges to arbitrageurs also is inconsistent with the concept of arbitrage itself. The benefits of arbitrage are supposed to result from trading acumen in being able to spot divergences between markets. As stated above, arbitrageurs create their own load by the volume of their trades. ***If 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.***

Black Oak Energy, LLC v. PJM Interconnection, LLC, Order Denying Complaint, 122 F.E.R.C. ¶ 61,208 at P 51 (Mar. 6, 2008) (emphasis added). The Commission addressed the very same issue about including virtual traders in the allocation of transmission loss credits when it considered Black Oak Energy's request for rehearing of the Commission's Order denying the complaint:

> Complainants further claim that they are entitled to a large portion of the marginal line loss surplus because the Commission has recognized the value of arbitrage in energy markets. We do not dispute the value of arbitrage in energy markets. However, such arbitrage is valuable because the arbitrageur faces the marginal cost of energy and can therefore make transactions that reduce price divergence between the Day-Ahead and Real-Time markets. For arbitrage to be effective, arbitrageurs therefore should pay and receive the market price for energy, which in this case includes marginal line losses. As long as arbitrageurs receive and pay the marginal energy price, arbitrage is not jeopardized, and we see no entitlement to additional payment of surplus unrelated to the transmission charges. ***Indeed, 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.***

Black Oak Energy, Order Denying Reh'g in Part & Granting Reh'g in Part, 125 F.E.R.C. ¶ 61,042 at P 43 (Oct. 16, 2008) (citing Complaint Order, 122 F.E.R.C. ¶ 61,208 at P 51) (emphasis added). In the same order, the Commission also observed in a footnote that paying transmission loss credits to financial traders "would provide an incentive for the arbitrageurs to conduct trades simply to receive a larger credit." *Id.* at 125 F.E.R.C. ¶ 61,042 at P 38 n.46.

Ultimately, the Commission approved the inclusion of virtual traders in the allocation of TLCs with no limitation other than that the traders pay into the fixed costs of the system, which as the Commission expressly recognized, would include UTC transactions. *See Black Oak Energy*, Order Accepting Compliance Filing, 128 F.E.R.C. ¶ 61,262 at P 26 (Sept. 17, 2009) ("As PJM acknowledges, some arbitrageurs or virtual traders pay transmission access charges related to Up-To Congestion transactions, which contribute to the fixed costs of the transmission system, and which should be included in the allocation process . . ."). Thus, having at least *twice* addressed the issue of including virtual traders in the allocation of TLCs, the Commission nevertheless requested that PJM revise its tariff to include UTC virtual traders. And despite having had the opportunity to circumscribe the very conduct at issue in this matter, the Commission did not ask PJM to limit or qualify the virtual traders' receipt of rebates for UTC transactions, nor did the Commission issue any pronouncement or order advising virtual traders that it would consider trading for the rebates to be wrongful conduct. In other words, (1) the Commission evaluated and assessed how adding TLC payments would affect trading behavior, (2) changed the incentives of the trade, and (3) never cautioned that there would be anything

unlawful about virtual traders following those incentives. In sum, the Commission anticipated that traders would alter their behavior – and that is exactly what happened.[3]

Moreover, in Order No. 670, which implemented the Anti-Manipulation Rule, the Commission established a "safe harbor" whereby "[i]f a market participant undertakes an action or transaction that is explicitly contemplated in Commission-approved rules and regulations, we will presume that the market participant is not in violation of the Final Rule." *See Prohibition of Energy Mkt. Manipulation*, 114 F.E.R.C. ¶ 61,047 at P 67 (Jan. 19, 2006) ("Order No. 670") (setting forth the elements of the Commission's anti-manipulation rule, codified at 18 C.F.R. §1c2(a) (2006)). That is the situation here: as explained above, the relevant Commission orders explicitly contemplated – indeed, they explicitly *said* – that including virtual traders in the allocation of transmission loss credits would encourage them, for example, to "make trades that would not be profitable based solely on price differentials alone" and to "engage in purchase decisions, not because of price divergence, but simply to increase marginal line loss payments." If the safe harbor does not apply here, that portion of Order No. 670 is utterly meaningless.

There is nothing complicated or ambiguous about this. You don't have to be a constitutional law professor or claim to be an expert on energy markets to understand the import

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[3] The Report tries to make it seem like Dr. Chen was some sort of rouge outlier, as if he were the only trader crazy enough to contemplate trades that he otherwise would not have made, absent the rebate. *See* Report at 59-61, 67. The facts are just the opposite. The Report states that nine market participants were investigated and that Dr. Chen traded for three of them. *See id.* at 68. According to Appendix C of the January 6, 2011 Report from the IMM of PJM, entitled "PJM Marginal Loss Surplus Allocation and Market Participant Transaction Activity: May 15, 2010 through September 17, 2010," there were 56 trading participants that received TLCs (including the three that Dr. Chen traded for, Powhatan, HEEP Fund and CU Fund). This means that approximately 13% (7/54) of the individual traders in the UTC market were aggressively pursuing the rebates – and the actual percentage is likely higher than that because the chart in Appendix C redacts the names of the trading participants (other than Powhatan, HEEP and CU), so it is not possible to tell if there are "duplicates" in the chart such that a single trader was making trades for multiple companies, which would decrease the denominator in the 7/54 fraction. Prior to the summer of 2010, the UTC market had existed for approximately a decade without anybody being accused of market manipulation. But within a year of the rule change, FERC was actively investigating at least 13% of the traders. That is powerful evidence that the new rules incentivized the behavior at issue, which is what the Commission predicted would happen.

of the relevant orders here. All you have to do is know how to read. Given the above, how can Powhatan possibly have received fair notice that the trading at issue was illegal? What does the Report say about this? The Report makes two arguments, neither of which can be taken seriously. First, it says that certain parties (the "Financial Marketers' coalition") in the *Black Oak* proceedings "promised" that they wouldn't make trades for the purpose of receiving rebates, and second, it says that the relevant orders should be read to have "condemned" the very trading that they allow. Report at 59-71. (Tellingly, the Report says nothing about the safe harbor in Order No. 670.)

As to the first argument – who cares? It does not matter what any of the parties in the *Black Oak* proceedings did or did not promise. It is axiomatic that the Commission speaks through its orders – not through what certain parties may or may not have said to the Commission.

The same goes for the second argument: it does not matter what the Staff thinks the Commission *meant to say* in its orders. Because the Commission speaks through its orders, all that matters is what the orders *actually say*. The orders note the consequences that the Commission anticipated if it approved the new revenue stream provided by the rebates (specifically, that traders would make trades that were uneconomical absent the rebates) and then the orders approve this new revenue stream – never stating that there were any legal problems with those envisioned consequences. Under the Staff's tortured reading, however, the orders also say "and furthermore we condemn these consequences, think that they are illegal and that nobody should trade this way." But they *do not* say that, or anything like it. *See, e.g.*, Sworn Statement of William W. Hogan, at 4 ("There was a market defect in the poorly crafted rules for loss surplus allocation. The rule was adopted in the full light of day, with explicit discussion of

the incentive effects and the likely implications for trading strategies of market participants. This was not a hidden flaw. The market feature was already known and accepted by the Commission."). It would be completely bizarre for the Commission to issue orders requiring PJM to pay rebates to UTC traders, and in the same orders state that it would be market manipulation for traders to seek to collect those payments – but that is exactly how the Staff thinks the orders should be read.

The Staff's reading of the relevant orders is so preposterous that even Joseph Bowring, the Independent Market Monitor (IMM) for PJM, knows that the Staff is wrong. Dr. Bowring clearly did not like the trading at issue and wanted to stop it, but he understood that the existing market rules incentivized traders to, as the orders put it, "make trades that would not be profitable based solely on price differentials alone" and to "engage in purchase decisions, not because of price divergence, but simply to increase marginal line loss payments." Dr. Bowring called Dr. Chen on August 2, 2010 and asked him to stop the trading at issue, which he did. *See* Report at 30. (Dr. Bowring also told Dr. Chen that he wouldn't report him to FERC if he stopped the trading, but then Dr. Bowring went back on his word and reported Dr. Chen, anyway.) In any event, in a recorded conversation with another UTC trader who is a target of the Staff's UTC investigation, Dr. Bowring discussed the relevant trading, where traders pursue trades that they otherwise would not, absent the rebates. Dr. Bowring had this to say about the existing market rules:

> And ultimately, and ultimately, to try to get the, the rule, the rule changed because, I mean, ***it's incenting this behavior***, which is designed to make money from the fact that we have this weird discontinuity in the rules ***and I understand why, why your traders would be doing it***. . . . And again, I want to be clear, I want to be clear . . . you're not violating the rules.

Staff's Answer in Opp'n. to Expedited Mot. for Two-Week Extension of Time at Exhibit B-1, (Jan. 29, 2015) (emphasis added).

Thus, even Dr. Bowring admits that UTC traders were "incentivized" to make the trades at issue here. He "understands" why the traders would be doing it. And he wants the rules to be "changed." This could not be more different from the Staff's view of things. According to the Report, nobody was "incentivized" to trade this way – after all, the Commission had supposedly already "explicitly condemned" the trading at issue and had a "long history" of calling this type of trading manipulative. Report at 67, 74. Logically, then, there would be no need to "change" the rules; the only people who would trade this way would be rouge traders like Dr. Chen (and Powhatan) who knew that they were breaking the law and knew that they were executing a "scheme," but did it anyway because they wanted to make a lot of money. *See id.* at 75-77.

Yet, incredibly, the Staff insists that the Bowring tape is not *Brady* material or in any way exculpatory (thereby supposedly justifying their decision not to disclose the recording to Powhatan and Dr. Chen until January 29, 2015, after we learned of it from other sources and filed a motion, demanding disclosure). In fact, the Staff thinks that Dr. Bowring's statements are either irrelevant or inculpatory. *See* Staff's Answer in Opp'n. to Expedited Mot. for Two-Week Extension of Time, at 3-6. With that upside-down view, little wonder that the Staff has compiled such an abysmal record to date regarding its *Brady* obligations. As Commissioner Bay's recent written testimony to the Senate confirmed, OE in the last five years has identified and produced exculpatory materials under its *Brady* policy only *twice* in public investigations. Frankly, that is pathetic – but entirely consistent with what we have seen thus far in this investigation.[4]

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[4] The Staff's arrogant, dismissive attitude towards its *Brady* obligations is also consistent with its overall approach in this matter. As we have pointed out previously, the lead investigator, Mr. Tabackman, fell asleep for a sustained period of time during the first deposition of Kevin Gates. *See* Letter from William M. McSwain

(cont'd)

2. *The Due Process Concerns Evident In FERC's National Fuel Marketing Company Investigation Are Instructive Here.*

With the above background in mind, it is worth reviewing a recent FERC case in which due process concerns took center stage and ultimately led the Office of Enforcement to drop its market manipulation claim. In 2009, OE recommended that the Commission issue an order to show cause and notice of proposed penalties against National Fuel Marketing Company, LLC ("NFM") for alleged violations of the Commission's market manipulation rule and the Commission's shipper-must-have-title requirement. *See Nat'l Fuel Mktg. Co., LLC, et al.*, Order to Show Cause and Notice of Proposed Penalties, 126 F.E.R.C. ¶ 61,042 (Jan. 15, 2009) ("NFM Order to Show Cause"). The claims against NFM arose out of OE's investigation into bidding for interstate natural gas transportation capacity on Cheyenne Plains Gas Pipeline Company ("Cheyenne") in March 2007. At that time, Cheyenne had posted an open season notice inviting bids for its unsubscribed capacity. In response, NFM and three of its subsidiaries each placed bids and subsequently were among the 48 "winning" bidders awarded a pro rata allocation of the available capacity.

Following the close of the bidding, however, OE received complaints from other market participants who claimed that some bidders had submitted multiple bids through affiliated companies in order to "game" Cheyenne's pro rata allocation. OE opened investigations into several bidders, including NFM, who had engaged in multiple affiliate bidding and ultimately

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to Steven C. Tabackman, dated Jan. 13, 2012. Mr. Tabackman has never denied this – because he can't. There were too many witnesses. Mr. Tabackman also pulled Mr. Gates' counsel aside after Mr. Gates' second deposition and said to him: "Kevin's a businessman, isn't he? He knows that it's cheaper to settle than to fight this investigation." Mr. Tabackman's dismissive attitude is also evidenced by the fact that when Powhatan submitted its original position statement after the close of business on Friday, October 21, 2011 – which consisted of 35 pages of legal argument, over 40 pages of expert affidavits and a massive binder of attachments – Mr. Tabackman and his colleague, Tom Olson, called Powhatan's counsel on the very next business day, Monday, October 24, 2011, to say that they had rejected everything that Powhatan had presented.

alleged that their conduct violated the Commission's market manipulation rule. Four of those bidders chose to settle with the Commission and agreed to pay civil penalties and disgorge profits related to the Cheyenne bidding. NFM decided to contest the allegations.

In January 2009, OE convinced the Commission to issue a show cause order against NFM. The order was issued over the strong dissents of two of the five Commissioners, Philip D. Moeller and Marc L. Spitzer. Significantly, the dissents of both Commissioner Moeller and Commissioner Spitzer were based on due process.

In his dissent, Commissioner Moeller concluded that NFM did not have advance notice that multiple affiliate bidding could be a violation of the Commission's market manipulation rule. Commissioner Moeller chastised the Commission for issuing an order against NFM that "violat[ed] th[e] principle of fundamental fairness." NFM Order to Show Cause, Moeller, Commissioner dissenting at 1 ("Commissioner Moeller Dissent"). Specifically, he noted that he had "stated twice in the last year [that] '[t]hose who are subject to Commission penalties need to know, in advance, what they must do to avoid a penalty.'" *Id.* (citing *Enforcement Statutes, Regulations, and Orders* 123 F.E.R.C. ¶ 61,156 (2008) (Moeller, Commissioner concurring) and *Compliance with Statutes, Regulations, and Orders* 125 F.E.R.C. ¶ 61,058 (2008) (Moeller, Commissioner concurring)).

Yet the Commission had ignored that basic principle by issuing an order to show cause against NFM, which violated due process because (1) OE's interpretation of what constituted 'legitimate' multiple affiliate bidding was not disclosed to the bidders, including NFM, on the Cheyenne open season until *after* OE launched their market manipulation investigation; (2) the Commission had previously declined to address the issue of legitimate multiple affiliate bidding when faced with the very same issue following the Trailblazer open season several years before;

and (3) the Commission likewise did not take the opportunity to change its policy with respect to interstate pipelines such as Cheyenne when it had previously addressed the issue of multiple affiliate bidding in the context of the Alaska pipelines. *See* Commissioner Moeller Dissent at 3-7.

Although Commissioner Moeller noted that as part of the Trailblazer investigation, OE had asked Trailblazer to notify the industry that bidders could not "game" the system by using affiliate bids, he concluded that "notification by a pipeline is not equivalent to a Commission order" and he further noted that even OE Staff recognized this in their report: "'***[I]t is a well-settled principle that the Commission speaks through its orders, not the absence thereof.***'" *Id.* at 6 (quoting NFM Report at 27) (emphasis added). Finally, in addition to his due process concerns, Commissioner Moeller also found "fundamental flaws" in OE's claims of market manipulation against NFM because he noted that "fraud almost universally involves an allegation of concealment or misrepresentation," and such allegations were absent from the Staff's report on NFM's conduct. *Id.* at 7.

Similarly, Commissioner Spitzer dissented from the show cause order because he found that over the years the Commission had been "less than clear" and had sent a "mixed message" to the industry about the propriety of multiple affiliate bidding. *Statement of Commissioner Marc Spitzer on Enforcement Actions* at 1 (Jan. 15, 2009) ("Commissioner Spitzer Dissent"). As such, he found that "[a] reasonable mind could have concluded multiple-affiliate bidding was not unlawful." *Id.* at 3. Thus, he concluded that "the Commission should have used the[] proceedings to first provide guidance regarding multiple-affiliate bidding practices rather than impose civil penalties." *Id.*

In February 2009, NFM responded to the show cause order and requested rehearing. *See Nat'l Fuel Mktg. Co., LLC, et al.*, Dkt. No. IN09-10-000, Answer of Nat'l Fuel Mktg. Co., LLC, et al. in Opp'n. to Order to Show Cause & Notice of Proposed Penalties & Alt. Mot. for a Formal Evidentiary Trial-Type Hr'g Before an Admin. Law Judge and Request for Reh'g of Nat'l Fuel Mktg. Co., LLC, et al., (Feb. 17, 2009). NFM continued to fight the allegations of market manipulation for an additional two years.

In April 2011, NFM and OE reached a settlement. OE dropped the market manipulation claim against NFM in its entirety, including the bulk of its originally recommended $4.5 million civil penalty, and NFM agreed to pay a minimal fine to settle the lesser claim of violating the Commission's shipper-must-have-title requirement. *See Nat'l Fuel Mktg. Co., LLC et al.*, Order Approving Stipulation and Consent Agreement, 135 F.E.R.C. ¶ 61,011 (Apr. 7, 2011).

The similarities between the NFM matter and the instant matter are palpable. Here, as in NFM, no Commission order or express regulation or rule ever alerted Powhatan that trades motivated by the collection of TLCs were unlawful. It was only *after* OE began its investigation into the UTC transactions on the PJM system that Powhatan learned that the Commission may view such transactions as prohibited. Moreover, here, Powhatan had even *less* notice than NFM because there were no prior investigations into the conduct at issue nor any industry pronouncement that even could have theoretically alerted Powhatan to the potential danger.

Also, similar to NFM, the Commission had the opportunity to prevent the very conduct at issue but declined to act. What is more, in this case, the Commission actually took the affirmative step of including virtual UTC traders in the allocation of transmission loss credits when they were not included previously, despite the Commission's express recognition that TLCs create incentives for virtual traders to engage in "volume"-based trades targeting the

credits. This goes well beyond the "mixed messages" that concerned Commissioner Spitzer in NFM. Having predicted that allocating transmission loss credits to UTC virtual traders would result in volume-based transactions aimed at profiting from the collection of those credits, FERC cannot claim now that Powhatan's UTC transactions were fraudulent.

Finally, just like in NFM, there is no evidence that Powhatan or Dr. Chen concealed or misrepresented anything related to the UTC transactions. As noted above, the transactions were conducted in a transparent manner. Dr. Chen accurately entered the information necessary to effect the transactions, which were carried out openly and he did not attempt to hide, conceal, or misrepresent anything.

3. *The Relevant Due Process Case Law Is Overwhelmingly In Powhatan's Favor.*

Just in case there is any remaining doubt about the due process violation here, let's review the most relevant and analogous federal court precedents.

For example, in *Upton v. SEC*, 75 F.3d 92 (2d Cir. 1996), the U.S. Court of Appeals for the Second Circuit found a due process violation in circumstances in which the individual there had much more notice than Powhatan had here. In *Upton*, the SEC brought an action against Mr. Upton, the chief financial officer of the brokerage firm FiCS, for failing to supervise an employee who allegedly aided and abetted a violation of SEC Rule 15c3-3(e), which was designed to prevent broker-dealers from using funds or securities on behalf of customers to finance non-customer transactions. Specifically, that rule required brokers to use a "special reserve bank account" and specified that computations to determine the minimum amount to be kept in the account were to be made "weekly, as of the close of the last business day of the week" and the deposit should be made "no later than 1 hour after the opening of banking business on the second following business day." *Id*. at 93.

At issue, FiCS engaged in a "pay-down" practice where the firm's money management department "paid down loans collateralized by customer securities just before the weekly Rule 15c3-3(e) computation and replaced them with unsecured loans" at a higher interest rate. *Id.* On the next business day, FiCS paid down the unsecured loans and "reinstated the customer-secured loans." *Id.* By doing this, FiCS was able to reduce its weekly reserve requirement by "$20 million on average and by as much as $40 million in some weeks." *Id.* at 94.

FiCS engaged in this "pay-down" practice from April 1988 until May 26, 1989. In November 1988, an NYSE examiner contacted an assistant in the money management department and advised that the "pay-down" practice was "questionable and should be stopped." *Id.* at 95. However, the head of the department ignored the warning. In May 1989, Mr. Upton received a telephone call from SEC staff advising him that the "pay-down" practice "violated the spirit of [the] Rule." *Id.* Mr. Upton then instructed the firm's money management department to stop the practice.

On August 23, 1989, the SEC circulated an interpretation memo, in which "for the first time it advised its members and member organizations that the paydown practice might violate Rule 15c3-3(e)." *Id.* Two years later, the SEC instituted public proceedings against Mr. Upton and the head of his money management department, alleging that his firm's "pay-down" practice from April 1988 until May 1989 violated Rule 15c3-3(e) by resulting in reserve bank account deficiencies averaging $20 million per week, placing broker-dealers and customers at "substantial risk." *Id.*

An evidentiary hearing was held before an ALJ, who issued an initial decision censoring Mr. Upton. The ALJ held that the FiCS's "pay-down" practice was "simply a device designed to evade the requirements of [Rule 15c3-3(e)]." *Id.* at 96. The ALJ further found that "[b]ecause

FiCS was able to use customer funds to finance proprietary activities, the very practice the Rule was designed to prevent, FiCS did not require specific notice that this circumvention of the Rule amounted to a violation." *Id*. The SEC affirmed the ALJ's decision. The Second Circuit reversed.

Mr. Upton claimed that he should not have been held liable for violating the rule because "the Commission knew about the paydown practice well before the underlying events in th[e] action took place and yet did not publicly condemn it until Interpretation Memo 89-10 was released on August 23, 1989." *Id*. at 98. Upon review of the facts, the court noted that it was "undisputed that FiCS complied with the literal terms of the Rule at all times." *Id*. at 94. The court also noted that the SEC had begun investigating the paydown practice at several firms "as early as 1986" and had "referred several such 'violations' of Rule 15c3-3(e) to the New York Stock Exchange and [had] instructed individual broker-dealers to discontinue the practice." *Id*. at 97. However, the Exchange had informed the SEC that it would not cite the firms for any violations because there had been no written interpretation with respect to the practice. In December 1987, the SEC brought an administrative proceeding against another brokerage firm for engaging in a "pay-down" practice. That case had settled and the SEC had issued a consent order. *Id.*

In vacating the SEC's order, the Second Circuit noted that the SEC "was aware that brokerage firms were evading the substance of Rule 15c3-3(e) by temporarily substituting customer loans on the Rule's computation date as early as 1986, two years before the events in this case took place. Apart from issuing one consent order carrying 'little, if any, precedential weight,' **the *Commission took no steps*** to advise the public that it believed the practice was questionable until August 23, 1989, after Upton had already stopped the practice." *Id*. at 98

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(emphasis added). Accordingly, the court found that the SEC's order censoring Mr. Upton violated due process because Mr. Upton "was not on reasonable notice that FiCS's conduct might violate the Rule." *Id*; *see also KPMG, LLP v. SEC*, 289 F.3d 109, 115-16 (D.C. Cir. 2002) (following *Upton* and concluding that the SEC erred in finding that KPMG was in violation of a rule prohibiting the receipt of contingent fees because KPMG did not have fair notice that its success fee arrangement ran afoul of the rule from "any interpretation . . . the Commission ha[d] ever attached to [the] Rule").

The due process violation here would be much more apparent than the violation in *Upton*. First, Mr. Upton and his firm's money management department had received a warning from an NYSE market monitor about their "pay-down" practice six months after they began engaging in that practice. Despite the warning, they continued to engage in the "pay-down" practice for *another six months* before the SEC told them to shut it down. Here, as soon as Dr. Chen received a warning from Dr. Bowring on August 2, 2010, he stopped conducting the trades in question. And second, although the SEC had issued a previous consent order following the settlement of claims related to a "pay-down" practice at another brokerage firm, that *still* was not enough to put Mr. Upton on reasonable notice that a "pay-down" practice was unlawful. Here, there were no prior PJM pronouncements or Commission orders related to the transmission loss credits even suggesting that Dr. Chen's trading was illegal. Just the opposite: the Commission had anticipated the type of trading at issue here and nonetheless approved PJM's inclusion of virtual UTC traders in the allocation of the transmission loss credits.

In addition to the *Upton* case, a recent decision out of the Southern District of New York is particularly relevant. In *SEC v. Pentagon Capital Management*, 844 F. Supp. 2d 377 (S.D.N.Y. 2012), *vacated in part on other grounds*, 725 F.3d 279 (2d Cir. 2013), the SEC

brought an enforcement action against Pentagon Capital Management PLC ("Pentagon") and Lewis Chester ("Chester"), Pentagon's former Chief Executive Officer, alleging that between 1999 and 2003, Pentagon and Chester had orchestrated a scheme to defraud mutual funds through late trading and deceptive market timing in violation of, among other things, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Following a bench trial, the court granted in part and denied in part the relief requested by the SEC. Although the court found violations of securities law related to defendants' late trading, the court concluded that the defendants had not engaged in market manipulation in violation of Section 10(b) and Rule 10b-5 by pursuing a strategy of market timing.

With regard to the SEC's market timing claim, the court noted that prior to 2003, there were no clear rules regarding market timing. *Id*. at 414. The court observed that prior to 2003, "the SEC had never commenced an enforcement proceeding against any mutual fund, market timer, or securities firm for market timing." *Id*. at 392. Specifically, the court stated:

> ***Defendants' actions thus took place in an atmosphere of uncertainty.*** There were no definitions or prohibitions from the responsible agency with respect to market timing, and the funds' enforcement of their provisions relating to timing was discretionary, inconsistent, and occasionally conflicted with capacity agreements. The SEC issued no guidelines as to which fund provisions it might seek to enforce and, of course, prior to the Canary enforcement action by the NYAG in September 2003, the SEC had not initiated any proceedings to obtain the relief sought here.

Id. at 415 (emphasis added). Indeed, it was only after the time period at issue, in April 2004, that the SEC adopted a market timing rule requiring mutual funds to disclose their policies toward market timing. *Id.* at 392.

Accordingly, the court concluded that ***"the lack of regulation or clear rules or practices regarding market timing during the period in question cannot be remedied by a finding of***

***liability.*"** *Id*. at 418 (emphasis added). "Litigation in the absence of clear standards may further raise due process concerns, upsetting the basic notion that individuals have fair notice of the standards under which they may be held liable. Prospective regulation by the SEC and clear rules by the funds are preferable to *post hoc* litigation." *Id*. (citation omitted). Those words are of particular force here.

In the instant matter, just as in *Pentagon*, there were no guidelines or prohibitions from the Commission or any pronouncements from PJM with respect to the collection of TLCs. Powhatan had no way of knowing that responding to the incentives created by the TLCs could be considered prohibited conduct. Given that the Commission had specifically acknowledged such incentives and declined to prohibit or discourage trading influenced by such incentives, Powhatan had every reason to believe that the trading was lawful. The paramount concern of due process is "that individuals have fair notice of the standards under which they may be held liable." *Pentagon*, 844 F. Supp. 2d at 418. That concern is obviously front and center here.

While *Upton* and *Pentagon* are particularly relevant, there is an overwhelming amount of additional due process authority that would bar any liability here for supposed market manipulation.[5] The bottom line is that FERC would be laughed out of federal court if it argued

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[5] *E.g., FCC v. Fox Television Stations, Inc.*, 132 S. Ct. 2307, 2320 (2012) (setting aside notices of liability because broadcasters did not have sufficient notice of what was proscribed); *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 510 (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); *United States v. AMC Entm't*, 549 F.3d 760, 768 (9th Cir. 2008) (stating that "those regulated by an administrative agency are entitled to know the rules by which the game will be played" and holding that fair notice precluded the lower court from requiring AMC to retrofit its theatres built before the government announced its interpretation of the statute at issue) (internal citations omitted); *Fabi Constr. Co., Inc. v. Sec'y of Labor*, 508 F.3d 1077, 1085-86 (D.C. Cir. 2007) (holding that petitioners were deprived of fair notice because secretary announced its interpretation of regulation for the first time in an adjudicatory proceeding); *Trinity Broad. 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"); *Beaver Plant Operations, Inc. v. Herman*, 223 F.3d 25, 32 (1st Cir. 2000) (holding that fair notice doctrine prohibited OSHA from sanctioning employer for violating an agency guideline that was unknown to the employer until after the date of the alleged

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that Dr. Chen and Powhatan had adequate notice that the trading at issue was illegal. That is not in anybody's best interests – it is not good for the Commission's reputation or for the agency as a whole, and Powhatan and Dr. Chen would of course prefer that this matter end now, as it should.

C. The Report Contains So Many Obviously Wrong Accusations That Some Additional Comments On the Most Blatant Inaccuracies Are Warranted.

As discussed above, this case should be terminated on due process grounds. It is not necessary to dig any further into the Report in order to arrive at that conclusion. But the Report is so thoroughly littered with erroneous and illogical accusations that Powhatan feels obligated to make a few additional comments – or at least respond to the biggest whoppers. There are so many that it's hard to know where to start. But maybe we should just start with some simple math.

1. *Dr. Chen's "Home Run" Trading Strategy Is Not A "Post Hoc Invention" Because, Among Other Things, 35 Is Less Than 50.*

Dr. Chen's trading was not as simplistic as the Staff would have the Commission believe. He did not make trades *just* to collect rebates. Rather, he employed a "spread trading" strategy in which he hoped to hit it big (or hit a "home run") if one of the legs of his trades did not clear. Consistent with this strategy, he frequently entered into trades at less than the maximum

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violation); *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1329 (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)); *Satellite Broad. Co., Inc. v. FCC*, 824 F.2d 1, 3-4 (D.C. Cir. 1987) (stating that "[t]raditional concepts of due process incorporated into administrative law preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule" and vacating FCC's orders dismissing applications where FCC failed to give full notice of its interpretation); *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]"); *Peterson v. ConAgra Foods, Inc.*, No. 13-cv-3158-L (NLS), 2014 WL 3741853 (S.D. Cal. July 29, 2014) ("To hold that ConAgra should have been complying with a regulation that was not explicitly clarified until November 19, 2012 would violate due process because ConAgra was not on fair notice.").

congestion limit of $50/MWh (often choosing $35/MWh instead), thereby intentionally increasing the possibility that one of the legs would be rejected. This exposed Dr. Chen and Powhatan to a greater possibility of profit (as well as a corresponding greater risk of loss).

The only conceivable purpose to Dr. Chen sometimes using a cap lower than $50/MWh, such as $35/MWh, was to increase exposure to a leg not clearing. If, as the Staff alleges, Dr. Chen always wanted both legs to clear and was only concerned with minimizing the risk of his trades, *then he would have always bid at the maximum congestion limit*. This is not a point that can be disputed – it is mathematical fact. Dr. Chen and Powhatan have repeatedly explained the details of this spread trading strategy to the Staff over the past four years.[6]

Nevertheless, the Report alleges that it's all made up. It calls the strategy a "post hoc invention" that was developed "by Respondents' experts." Report at 42, 57. What does the Report have to say, then, about Dr. Chen's frequent bids below the maximum congestion cap? The same thing that the Staff has been saying about it for the past four years – that is, absolutely nothing. This point goes completely unaddressed. Maybe the Staff thinks that nobody will notice. Or perhaps that it will be able to convince the Commission that 35 is not less than 50.[7]

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[6] The discussion on pp. 9-14 in Mr. Estes' September 24, 2014 letter to the Staff is particularly instructive.

[7] The Report points to the lack of email traffic between Dr. Chen and Kevin Gates during the summer of 2010 regarding the "home run" strategy. *See* Report at 44, 46. This is of no consequence, as Dr. Chen had no obligation (contractual or otherwise) to share all the details of his trading strategy with Mr. Gates – although he did, of course, discuss the rebates with him because that was such an obvious component of the trading. Contractually, Dr. Chen had the power to choose the trades and the trading volumes and did not need any approval from Powhatan beforehand to enter into trades. Indeed, Mr. Gates, who was not an energy trader, understood that Dr. Chen guarded some of the details of his trading and was not obligated to share those details. *See, e.g.*, *id.* at 26 ("Gates believed that Chen 'had some sort of model that I wasn't privy to where he was able to model the expected transmission loss credits.'").

2. *The Staff's Analysis Of The "Indicia of Manipulation" Misses The Mark Entirely.*

The Report claims that Dr. Chen's trading bears "all the hallmarks of manipulation as clarified by recent Commission precedent." Report at 38. These indicia include: "(1) trading behavior inconsistent with supply and demand; (2) a marked difference in the trader's non-manipulative trading behavior versus the trading patterns of the manipulative scheme; (3) speaking documents that indicate the trader's intent; (4) whether the trades are uneconomic; and (5) failure to give plausible or credible explanations for the uneconomic nature of the trades." The Staff's analysis of these indicia leaves much to be desired.

First, the Report argues that the trading was inconsistent with supply and demand because "[t]he round trip UTC trades had no purpose at all other than to create a claim for MLSA." *Id*. Even if that were true, there would be nothing wrong with the trading at all. But as explained above, collecting rebates was not the *only* purpose of the trading: Dr. Chen used a spread trading strategy in which he hoped to hit a "home run" if one of the legs did not clear. There is no way around the fact that 35 is less than 50.

Second, the Report announces that there was a "sharp contrast" between Dr. Chen's previous trading and the trading during the summer of 2010, and that "Gates was aware and understood that they were doing something fundamentally different." *Id.* at 40. The response to that is – no kidding. The rules and the economics had changed. Saying that this is somehow indicative of manipulation makes about as much sense as saying that 35 is not less than 50. But the Staff apparently has no problem saying it.

Third, the Report declares that "Respondents' intent is not reasonably in dispute." *Id.* at 41. It is right about that – the intent was to make money, lots of it. And there is nothing wrong with that. Indeed, as noted above, Dr. Chen even had a fiduciary duty to Powhatan to try to

maximize the profits he could make from the rebates. The Report also chastises Dr. Chen and Mr. Gates for not consulting with an attorney about the legality of the trades, suggesting that their failure to do so is indicative of scienter.[8] *See id.* at 20-22, 75-77. But the concerns that they expressed to one another had absolutely nothing to do with being concerned about committing manipulation or fraud. Instead, they were simply concerned that PJM might have calculated the rebates incorrectly or might be crazy enough to try to change the rules retroactively and claw back rebates that had already been paid. Ultimately, they decided that was a risk worth taking and certainly had no obligation to consult with an attorney about it. Eventually, PJM did try to claw back some rebates, but the United States Court of Appeals for the District of Columbia Circuit has, at least for now, disallowed it. *Black Oak Energy, LLC v. Fed. Energy Regulatory Comm'n*, 725 F.3d 230, 243 (D.C. Cir. 2013) (concluding that the Commission "acted arbitrarily and capriciously when it effectively ordered PJM to recoup the refunds" and remanding to the Commission).

Fourth, the Report claims that the trades were "uneconomic" because they would have lost money, absent the rebate. But that is just putting the rabbit in the hat by assuming that some price signals count and others do not. For Dr. Chen and Powhatan – and for any rational trader, for that matter – all price signals count. The rebates count. And they were a part of *each individual trade* because they were paid automatically to all purchasers of transmission in PJM. All the trades were undertaken with a profit motive. And those trades that made money after

[8] The Staff asserts that had Dr. Chen and Mr. Gates sought legal advice about the trades, "counsel . . . would have informed them conclusively that their scheme was improper and illegal." Report at 81. This is a curious statement, as it refers to "counsel" in general – presumably the Staff thinks that any qualified lawyer would have given such advice. This just shows how close-minded the Staff is when it comes to this matter. Drinker Biddle certainly would not have given such advice. Skadden would not have, either. Nor would have the former Director of Enforcement, Susan J. Court. The list of counsel who would have quickly recognized that the trading here was perfectly legal is a long one.

accounting for the rebates (which was most, but not all, of the trades) were, by definition, economic. *See, e.g.*, Sworn Statement of Terrence Hendershott, at 2 ("The FERC staff's preliminary findings seem to attach significance to the breakdown of the profitability of trading between the trading revenues based on transaction prices and trading fees/rebates. There is absolutely no economic basis for making such a distinction. All economic agents rationally view the total costs and benefits of their actions and choose their behavior accordingly.").

Finally, the Staff concludes that the spread trading or "home run" strategy is an "implausible explanation" for what Dr. Chen was really doing in the summer of 2010. Report at 42-47. But once again . . . 35 is less than 50 and always will be.

3. *Dr. Chen's Trades Were Not "Wash-like" Or "Wash-type" – Whatever The Heck That Means.*

Manipulative wash trades are bad: they are trades that are designed to mislead other investors, make no money, take on no risk, cancel each other out and have no legitimate purpose. Is that what Dr. Chen was doing? Of course not. Even the Report does not come right out and call the trades "wash trades." Instead, it calls them "wash-like" or "wash-type," whatever that means. That's like saying somebody is in a "pregnant-like" or "pregnant-type" condition – and simply highlights that FERC could never demonstrate that the trades here were manipulative wash trades.

The Commission's anti-manipulation rule expressly requires the Commission to establish that the individual or entity it is seeking enforcement against acted with the requisite scienter. *See* Order No. 670 at P 49. This requirement is well-established in Rule 10b-5 precedent. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 195 (1976), the United States Supreme Court defined scienter in the context of a Rule 10b-5 claim to mean "a mental state embracing intent to deceive, manipulate or defraud." *Id*. at 193 n.12. One year later, in discussing the term "manipulation,"

the Supreme Court reinforced the scienter requirement in Rule 10b-5 market manipulation actions by noting that the "term [manipulation] refers generally to practices, such as wash sales, matched orders, or rigged prices, *that are intended to mislead investors* by artificially affecting market activity." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (emphasis added).[9] The Court also soon after clarified that the scienter requirement is equally applicable regardless of whether the plaintiff is a private party or an enforcement agency. *Aaron v. SEC*, 446 U.S. 680, 691 (1980) ("[T]he rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought.").

In order to plead and ultimately prove scienter, the Supreme Court has held that facts giving rise to a "strong inference" of scienter must be demonstrated. In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), the Court explained:

> The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite . . . scienter, a court must consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff . . . [T]he inference of scienter must be more than merely 'reasonable' or 'permissible' – ***it must be cogent and compelling, thus strong in light of other explanations***.

Id. at 323-24 (emphasis added).[10]

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[9] Based on such precedent, even in cases where the conduct, without a doubt, constituted wash trades or matched orders, courts have concluded that scienter is a separate element that still must be established. *E.g.*, *Rockies Fund, Inc. v. SEC*, 428 F.3d 1088, 1093 (D.C. Cir. 2005) (noting that defendants engaged in wash sales and matched orders but finding that "neither of these devices alone constitutes a securities violation. Section 10(b) (and, accordingly, Rule 10b-5) also requires a showing of intent and materiality.").

[10] *Tellabs* involved a private plaintiff, but as set forth in *Aaron v. SEC*, the requirement of proving scienter in Rule 10b-5 cases is the same for private litigants and the government. 446 U.S. at 691. Accordingly, the Supreme Court's articulation of the test for scienter is equally applicable in government enforcement actions. *E.g.*, *SEC v. Boling*, No. 06-1329 (RMC), 2007 WL 2059744, at *4 n.1 (D.D.C. July 13, 2007) (applying the Supreme Court's instruction in *Tellabs* to "take into account plausible opposing inferences" and to determine whether the

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Here, Powhatan had a legitimate economic purpose for the Up-to Congestion Transactions: profiting from *each* of the trades, which included the collection of transmission loss credits. *See, e.g.*, *United States v. Mulheren*, 938 F.2d 364, 368 (2d Cir. 1991) ("When the transaction is effected for an investment purpose, the theory continues, there is no manipulation, even if an increase or diminution in price was a foreseeable consequence of the investment."); *SEC v. Masri*, 523 F. Supp. 2d 361, 373 (S.D.N.Y. 2007) ("[I]f a transaction would have been conducted for investment purposes or other economic reasons, and regardless of the manipulative purpose, then it can no longer be said that it is 'artificially' affecting the price of the security, or injecting inaccurate information into the market, which is the principal concern about manipulative conduct.").

As should be obvious by now, Dr. Chen was rationally responding to price signals when taking the TLCs into account in his trades. Significantly, the Commission itself has found that the existence of a pricing incentive is evidence of a *lack* of fraudulent intent:

> [T]he existence of a pricing incentive is suggestive of the *lack* of a fraudulent device, scheme or artifice, and is indicative instead of market participants responding to existing prices, rather than artificially affecting them.
>
> * * *
>
> Since NYISO itself has identified a clear economic pricing incentive for the transactions, since the market participants agree that they placed the schedules in response to prices, and since the market participants did in fact make a profit on their Path 1 and Path 5 trades, there seems no reason to doubt that their motive was simply one of responding to the price signals in the market.

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inference of scienter was "cogent and at least as compelling as any opposing inference one could draw from the facts alleged" in deciding whether the SEC had adequately pled scienter).

Federal Energy Regulatory Commission, *Non-Public Investigation into Allegations of Mkt. Manipulation in Connection with Lake Erie Loop Flows: Enforcement Staff Report*, at 22, 24 (June 10, 2009) (emphasis in original), adopted by the Commission on July 16, 2009. *See N.Y. Indep. Sys. Operator, Inc.*, Order Authorizing Pub. Disclosure of Enforcement Staff Report & Directing the Filing of an Additional Report, 128 F.E.R.C. ¶ 61,049 at P 1 (July 16, 2009).

Furthermore, profit-driven actions in response to similar pricing incentives in other contexts are common and not considered fraud. For example, in *Idaho Wind Partners 1, LLC*, Order Dismissing Without Prejudice Petition for Declaratory Order, 134 F.E.R.C. ¶ 61,217 (Mar. 17, 2011), the Commission found that offsetting energy transactions entered into for the sole purpose of accruing benefits associated with Renewable Energy Credits ("RECs"), which like TLCs are a credit revenue stream, did not constitute market manipulation. There, the sale and repurchase of energy cancelled each other out completely. The transactions thus served *no* purpose other than obtaining the value of the RECs. *Id*. at PP 6, 24. Likewise, another energy market credit, the Wind Energy Production Tax Credit ("PTC") for wind-generated electricity, creates the incentive for wind generators to *lose* money on the sale of electricity by offering zero or even negative bids into their respective markets in order to capture the PTC. The Commission has acknowledged that certain resources are incentivized to make negative bids in order to gain revenue via PTCs and has never suggested that there is anything fraudulent about this practice. *See Midwest Indep. Transmission Sys. Operator, Inc*., Order Conditionally Accepting in Part and Rejecting in Part Tariff Filing & Requiring Compliance Filings, 134 F.E.R.C. ¶ 61,141 at P 83 (Feb. 28, 2011).

The trades at issue here also were not wash trades because they entailed risk. This is another mathematical fact that cannot be disputed. For instance, Dr. Chen did not (and could

not) know ahead of time that the rebates would exceed the other costs associated with the trades. He speculated that they would, hoped that they would, took the *risk* they that would – but sometimes he was wrong and the trades lost money. As the Staff has previously acknowledged, this happened about 20% of the time. *See* Preliminary Findings of Enforcement Staff's Investigation, dated Aug. 9, 2013, at 23 ("[T]hroughout the period in which he employed his identical matched-pair strategy, over 80% of the hours in which Chen scheduled the matching UTC transaction and associated reserved transmission yielded a MLSA high enough to completely absorb transmission-related charges, market charges, and ancillary service charges related to those transactions."). And as the Report states, "[a] week and a half *after* he began implementing the round trip UTC trading strategy, Chen explained to Gates that, 'we increased volumes but decreased risk. If we rate the risk on 5/30 at 1.0, we now have probably 0.5.'" Report at 45 (emphasis in original). The Staff points to this quote as supposed evidence that the trades involved no risk – that the Respondents and their experts are just making it all up that the trades involved risk. But Dr. Chen had lost over $176,000 on May 30, 2010. *See id.* at 23. If he then shifted his strategy to cut the risk in half, the trades obviously still involved meaningful risk. How else can that statement possibly be interpreted? The fact that the Staff would think that this quote helps to show that there were no risks to the trading is a complete head-scratcher. But at least it does tend to fit the narrative: in the Staff's view, up is down, black is white, and losing money does not mean that there is any risk.

Finally, the trades did not cancel each other out (as wash trades would) because, among other reasons, many of the trades involved unmatched daily volumes, meaning the congestion elements did not cancel out in the aggregate. Thus, there was a directional bet on congestion for these unmatched-volume trades. *See* Letter from John N. Estes III to Steven C. Tabackman and

Samuel G. Backfield, dated Sept. 24, 2014, at 2, 8-14 (providing additional detail on the unmatched-volume trades and the spread trading strategy). This, too, is a mathematical fact that the Staff ignores.[11] Indeed, it is ironic that the Staff alleges that "Respondents' defenses generally do not address Chen's actual trading or trading strategy," Report at 58, when it is the Staff that ignores the trading data itself and the mathematical facts that many of the trades had unmatched volumes, some of the trades lost money and, of course, that 35 is less than 50. The Staff must be hoping that the Commission will just take the Staff's word for it, no matter how preposterous, and simply will not dig into any of the relevant details.

4. *The Staff's Stubborn Reliance On The Unpublished, Non-Precedential* Amanat *Case Is Just Lame.*

In order to establish that Powhatan engaged in market manipulation, the Commission must show that Powhatan: (1) used a fraudulent device, scheme or artifice, made a material misrepresentation or omission, or engaged in a deceitful or fraudulent act, (2) with the requisite scienter, (3) in connection with a Commission-jurisdictional transaction. *See* Order No. 670 (setting forth the elements of the Commission's anti-manipulation rule, codified at 18 C.F.R. §1c2(a) (2006)). The Commission has stated that its anti-manipulation rule is modeled after the Securities and Exchange Commission's ("SEC") Rule 10b-5[12] and that the Commission must

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[11] Underscoring the Staff's confusion on the wash trade issue is that, on the one hand, it likes to pretend that the trades were "self-cancelling" or "substantive nullities," Report at 50, 54, while on the other hand, it claims in the jurisdiction section that the trades "have the potential to affect the price of physical electricity," and were "integral . . . to the pricing and dispatch of physical energy," *id.* at 77, 79. This just shows that the Staff will change its tune when it thinks it suits its purposes, evidently without even realizing the contradiction.

[12] *See* 17 C.F.R. § 240.10b-5 (2005) ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) 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 (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.")

look to Rule 10b-5 precedent. *Id*. at P 7 ("[T]he Commission has modeled the Final Rule on Rule 10b-5. This approach will benefit entities subject to the new rule because there is a substantial body of precedent applying the comparable language of Rule 10b-5."); *id.* at P 30 ("We intend to adapt analogous securities precedents as appropriate to specific facts, circumstances and situations that arise in the energy industry . . . [This] will provide a level of substantial certainty with respect to how the regulations will operate that the Commission is not typically able to provide where a preexisting body of law and precedent is not readily available. The Commission likewise finds that modeling the Final Rule on SEC Rule 10b-5 provides clarity to affected parties similar to the clarity provided by Congress.").

In accordance with this directive, Powhatan and Dr. Chen have repeatedly brought relevant SEC authority to the Staff's attention. *See, e.g.*, Written Submission to Comm'n Investigation Staff on Behalf of Powhatan Energy Fund LLC, dated Oct. 21, 2011, at 4-22; Written Submission to Comm'n Investigation Staff on Behalf of Dr. Houlian Chen, dated Dec. 13, 2010, at 21-24; Supp. Submission on Behalf of Dr. Alan Chen, dated Mar. 16, 2012; Letter from John N. Estes III to Steven C. Tabackman and Samuel G. Backfield, dated Sept. 24, 2014, at 14-17. But they don't care – because the avalanche of SEC precedent in support of Dr. Chen and Powhatan does not fit the Staff's chosen narrative. So, despite the Commission's guidance, they try to bat all the SEC precedent away by saying that it really does not count. *See* Report at 71-72. Or, if it does count, the only thing that counts is one unpublished, non-precedential case in the Third Circuit, *Amanat v. SEC*, 269 F. App'x 217 (3d Cir. 2008). *See* Report at 73-74. *Amanat* is not going to save the day for the Staff.

As an initial matter, the *Amanat* court showed little enthusiasm for the SEC's findings, and only affirmed them because of the deferential standard of review. *Amanat*, 269 F. App'x at

220 ("Were we permitted to conduct a *de novo* review of the record, we might well reach a different conclusion with respect to certain of the Commission's findings."). Moreover, an unpublished opinion like *Amanat* has zero precedential weight.[13] So even if FERC, Powhatan and Dr. Chen end up litigating in the Eastern District of Pennsylvania (within the Third Circuit), no EDPA judge (or any other judge, for that matter) is going to care about *Amanat*.

In any event, the relevant facts in *Amanat* are unlike the facts here. In *Amanat*, the Third Circuit affirmed the SEC's finding that Irfan Amanat, the chief technology officer at MarketXT, an electronic communication network ("ECN")[14] broker-dealer, engaged in a fraudulent scheme to obtain market data rebates from Nasdaq by executing thousands of wash trades and matched orders through an automated trading program that he had designed. The similarities between *Amanat* and the trades here begin and end with the fact that *Amanat* involved a rebate.

In late 2001, Amanat learned that Nasdaq had instituted a rebate program to share with NASD members part of the revenue it received for selling transaction data, provided that the members met a minimum threshold of qualifying trades during the financial quarter. *In the Matter of Irfan Mohammed Amanat*, No. 3-11813, 2007 SEC LEXIS 2558, at *7 (Nov. 3, 2007) ("SEC Opinion"). MarketXT was eligible to participate in the program as an NASD member. Amanat "was aware that MarketXT had 'cash flow' problems" so he decided to try to qualify MarketXT for the rebate program for the March 2002 quarter. *Id.* at *8. However, by mid-March, MarketXT was not on pace to meet the minimum threshold requirement of qualifying

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[13] An unpublished decision holds no weight in the Third Circuit. *See* 3d Cir. I.O.P. 5.7 ("The court by tradition does not cite to its not precedential opinions as authority. Such opinions are not regarded as precedents that bind the court because they do not circulate to the full court before filing."). The panel echoed those limitations in their introduction to the opinion. *Amanat*, 269 F. App'x at 218 ("Because we write *only for the parties*, familiarity with the facts is presumed . . .") (emphasis added).

[14] An ECN is "an electronic trading system that automatically matches buy and sell orders at specified prices." *In the Matter of Irfan Mohammed Amanat*, No. 3-11813, 2007 SEC LEXIS 2558, at *3 n.2 (Nov. 3, 2007).

trades. *Id*. at *8-9 ("On March 11, 2002, Amanat heard from Nasdaq that, with three weeks left in the quarter, the firm was averaging only forty-nine qualifying trades per day, far less than the required daily average of five hundred trades.").

Recognizing that MarketXT would have to generate an enormous number of trades to qualify, Amanat enhanced an existing computer program ("RLevi2") to automatically send buy and sell market orders for the same number of shares of the same security within "milliseconds" at "regular, timed intervals." *Id*. at *11-12. Amanat executed the trades through two accounts at Momentum, a broker-dealer affiliated with MarketXT. *Id.* at *14. Amanat programmed RLevi2 to "cover[] every purchase order with a sell order to ensure that his position remained flat." *Id*. at *12. Amanat testified that he could also "shorten the time interval between buy and sell pairs of orders, thereby increasing the number of trades executed." *Id*. Between March 25 and March 27, 2002, Amanat ran RLevi2 in an attempt to meet the rebate program threshold. In doing so, he generated thousands of wash trades. *Id*. at *24-25 ("The trading data reveal[ed] that a total of 20,483 trades in Tape B securities were effected on MarketXT between March 25 and 27, 2002. Of those trades, seventy percent or over 14,000 of them were Amanat's wash and matched trades . . . ."). Because of those wash trades, executed through the two accounts at Momentum, Amanat was able to meet the rebate program minimum volume threshold and qualify MarketXT for the rebates. *Id*. at *25. Later that June, MarketXT received "nearly $50,000" in rebates from Nasdaq. *Id*.

Most importantly, unlike Powhatan or Dr. Chen, Amanat acted with scienter because his individual transactions had no legitimate economic purpose. *None* of Amanat's individual trades made money (or were intended to make money) or had any value at all. And Amanat never intended to profit from his trades: rather, he made his trades hoping to make money *later* on

account of the artificial volume that he had created. In contrast, the TLCs were part of the price signal for every single one of Dr. Chen's disputed trades.

Besides the absence of a legitimate economic purpose, many of the other traditional hallmarks of manipulation are present in the *Amanat* case. None of these are present in the instant matter.

First, Amanat's transactions undeniably constituted wash trades. Amanat even admitted this. *SEC Opinion*, 2007 SEC LEXIS 2558, at *16 ("Amanat admitted that the 1,696 trades in DIAs were 'wash trades.'"); *id*. at *39 ("Amanat [did] not dispute[] that his wash and matched trades involved no change in beneficial ownership."). Moreover, Amanat's own expert testified that "the element of risk involved in [Amanat's] trades was 'close to de minimis.'" *Id.* at *16. Consistent with the concept of wash trading, Amanat conducted his trades in accounts at one broker-dealer (Momentum) for the purpose of providing a subsequent benefit to *another* broker-dealer (MarketXT) from the artificial volume generated by his trades. In other words, Amanat's trades at Momentum were part of an artifice to make money later in some other fashion – namely, via rebate revenue to MarketXT.

Second, there was evidence that Amanat knew that what he was doing was wrong. He intentionally conducted wash trades for the purpose of benefiting later from their artificial volume. *Id*. at *13 (acknowledging that he "was familiar with the term 'wash trade'" and "knew that [it] was illegal, . . . [but] [n]onetheless . . . admitted that he did not program RLevi2 to prevent wash trading, although he could have done so."); *id*. at *20 ("After two days of running RLevi2 . . . Amanat was still thousands of trades short of the 18,000 trades needed to qualify for rebates. He decided to decrease again the number of seconds between his paired market orders.

He also adjusted the program so that each buy order preceded a sell order by seven hundred milliseconds.").

Third, at the end of the quarter, during his communications with Nasdaq about obtaining the rebates, Amanat intentionally concealed the fact that he had conducted wash trades. *Id*. at *23-24 ("On March 28, 2002, the day after he was told by Tradescape compliance and supervisory personnel that his trading was wrong, Amanat sent an e-mail to Nasdaq inquiring about rebates for his trades. He asked, '[C]ould you send me the list of trades we've done on [T]ape A and B, and tell me if we [MarketXT] qualified (crossing my fingers here!) Thanks!' Amanat did not reveal to Nasdaq that he had been on both sides of his trades, or that the firm had told him that his trading must stop."). This was a material misrepresentation or omission because Amanat "caused Nasdaq to believe that MarketXT had reached the trading threshold required to qualify for rebates . . . [which] triggered Nasdaq's payment to MarketXT of rebates for all of its reported trades, both legitimate and illegitimate." *Id*. at *29.

Finally, Amanat received the rebates for nothing. The trades that qualified him for the rebates were fictitious. And because they were fictitious, he was not entitled to the rebates, and thus, in a very real sense, he took rebates away from other market participants. *Id*. ("Amanat's trades through MarketXT caused Nasdaq to receive more than its proper share of market data revenue, thereby defrauding other CTA participants."). Powhatan, on the other hand, did not take transmission loss credits away from any other PJM member because Powhatan was entitled to the transmission loss credits based on its payment of the transmission costs and other fixed costs of the system – and the Commission itself had previously found that no entity was entitled to receive any particular amount of credits. *Black Oak Energy*, 125 F.E.R.C. ¶ 61,042 at P 12 ("[T]he Commission reiterated that no party is entitled to receive any particular amounts through

disbursement [of the credit that inevitably results from using the marginal line loss methodology], since the price each is paying (based on marginal line losses) is the correct marginal cost for the energy each is purchasing.") (citing *Black Oak Energy*, Order Denying Complaint, 122 F.E.R.C. ¶ 61,208 at P 46 (Mar. 6, 2008)).

In sum, even if *Amanat* had any precedential weight (which it does not), it still would not be relevant here. *See, e.g.*, Sworn Statement of Stewart Mayhew, at 4 ("The case brought by the FERC against Powhatan is not analogous to the SEC administrative proceeding brought against Mr. Amanat. Mr. Amanat's strategy involved wash trading, and Dr. Chen's strategy did not. The Division offered up a theory explaining why it believed Mr. Amanat's strategy was deceptive, and who was deceived; the FERC has not done so in its case against Powhatan. Mr. Amanat's trading platform would not have qualified for market data rebates had he not engaged in the wash trading strategy the Division alleged to be deceptive, whereas Dr. Chen's trades automatically qualified for the Marginal Loss Surplus Allocation payments. Mr. Amanat's strategy involved little or no risk, and Dr. Chen's strategy did involve risk.").

While the Report places far too much emphasis on *Amanat*, noticeably absent is any discussion of the *Kellogg* case – which was based on SEC precedent and is the case that most closely resembles the Staff's theory here. In 2004, a unanimous three-member panel of the National Association of Securities Dealers ("NASD," now the Financial Industry Regulatory Authority, or "FINRA") ruled in favor of Peter Kellogg and against the Department of Market Regulation on claims that Mr. Kellogg directed fraudulent wash and matched trades.[15] As a factual matter, there was no question that Mr. Kellogg indeed had engaged in matched trades

[15] The NASD panel in *Kellogg* was statutorily required to interpret and follow SEC law in issuing its decision. *E.g., Nat'l Ass'n of Sec. Dealers, Inc. v. SEC*, 431 F.3d 803, 806-07 (D.C. Cir. 2005) (explaining SEC oversight of the NASD).

with no change in beneficial ownership. But it did not matter because he had an economic motive for his trades – and that motive was simply to pay less taxes. If shielding money from the federal government is a "legitimate" enough economic motive to save an obvious matched trade scheme from securities liability, then surely the trades at issue here were legal.

The facts in *Kellogg* are worth a closer look. In early 2001, Mr. Kellogg invested hundreds of millions of dollars in IAT, an insurance company which he had founded. *Dep't of Mkt. Regulation v. Kellogg*, No. CMS030257, Disciplinary Proceeding, *available at* 2004 NASD Discip. LEXIS 64, *4-8 (Aug. 6, 2004) ("Hearing Panel Decision"). At that time, IAT was tax-exempt. *Id.* at *3. However, Mr. Kellogg expected that IAT would lose its tax-exempt status that coming November. IAT owned 100% of MMK, a Bermuda insurance company. At some point, IAT also had bought a controlling interest in MCM, a Delaware insurance company with $100 million in operating loss carry-forwards. MCM owned 100% of EH, a Delaware investment holding company. *Id.* at *4.

Mr. Kellogg was a significant investor in Thoratec Corporation ("THOR"). As of August 1, 2001, IAT held 2,033,500 shares of THOR and EH held 700,000 shares of THOR. *Id.* at *5. EH's shares of THOR had been purchased in February 2001 at just under $8.70. By August 2001, the price of THOR had risen to around $17, giving EH an unrealized gain on its shares. *Id.* at *5-6. Accordingly, as a wholly-owned subsidiary of MCM, EH could "offset any realized taxable capital gains on THOR by using MCM's loss carry-forwards before they expired." *Id.* at *7. As a long-term investor in THOR, Mr. Kellogg did not want to lose control of EH's shares. Thus, on August 1, Mr. Kellogg put in a sell order on behalf of EH for 700,000 shares of THOR; at the same time, he placed "an identical buy order on behalf of IAT, expecting the two orders would be crossed." *Id.* Trading records revealed that the trades were executed at

$18 per share and represented a hefty 54% of the trading volume in THOR that day. Six days later, on August 7, Mr. Kellogg placed a sell order on behalf of IAT for 1,000,000 shares of THOR. "[T]hat same day, he placed an identical buy order on behalf of EH." *Id.* The trades were executed at $17.50 and constituted around 70% of the trading volume in THOR. As a result of this trade, "IAT was able to realize gains on its investments in THOR before its tax exemption expired in November 2001." *Id.* at *7-8.

On August 9, Mr. Kellogg placed another sell order on behalf of IAT for 1,000,000 shares of THOR. "At the same time, he placed two buy orders for THOR, each for 500,000 shares[,]" one in a personal account and the other on behalf of MMK. *Id.* at *10. The trades were executed at $17.12 and represented a whopping 84% of the volume in THOR. "The purpose, again, was to take advantage of IAT's tax exemption before it expired in November." *Id.* On August 13, Mr. Kellogg reversed those trades. The trades were executed at $17.20 and constituted approximately 70% of the trading volume in THOR. Mr. Kellogg conducted the final trades to allow IAT to hold the same number of shares it held prior to August 9 because Mr. Kellogg wanted to remain a long-term investor in THOR. He also avoided margin interest on the 500,000 THOR shares in his own account and in MMK. *Id.* at *11.

Thus, Mr. Kellogg engaged in an obvious series of "matched orders." He placed identical, simultaneous buy and sell orders between his own accounts, thereby precluding any change in the beneficial ownership of those securities. He did this simply because he wanted to pay less taxes to the government. Based on those facts – which are far worse than any conceivable view of the facts here – the Hearing Panel unanimously concluded that Mr. Kellogg did not engage in market manipulation because he did not possess the requisite scienter.

In making its determination, the Hearing Panel rejected the regulators' argument – the same or at least substantially similar to the argument that the Staff is making here – that "wash trades" and "matched orders" are *per se* illegal and do not require an independent showing of scienter. *Hearing Panel Decision*, at *17-18. The Panel found that such a position flatly contradicted the Supreme Court's ruling in *Hochfelder*, as well as subsequent decisions addressing the interplay of Rule 10b-5 and the scienter requirement. *Id*. at *17-19. The Panel concluded that the regulators could not show scienter because "[t]here [was] no evidence that [Mr. Kellogg] had any motive for the trades, other than tax reasons and a desire not to reduce the size of [his company's] holdings of THOR. He had no motive artificially to affect the price of THOR or to induce others to trade the stock." *Id*. at *6. The Panel further concluded that Mr. Kellogg's trades were "effected in good faith" and there was "no evidence of any attempt or reason to manipulate the price of th[e] shares, to induce anyone to trade in th[e] shares, or to create the false or misleading appearance of market activity." *Id*. at *18-19. Finally, the Panel also noted that it found Mr. Kellogg's testimony credible that he "engaged in trades that he believed were bona fide, knew that they would be reported to the public, and made no attempt to conceal any aspects of his actions." *Id*. at *24.

The similarities between *Kellogg* and the instant matter are palpable. Like the NASD, the Staff here cannot show scienter because there is no evidence that Dr. Chen or Powhatan had any motive for the trades at issue, other than to make money via collection of TLCs and the possibility of gains if one of the legs did not clear. The trades were done in good faith; there is no evidence of any attempt to manipulate prices or to induce anyone else to make trades; and Dr. Chen and Powhatan engaged in trades that they believed were bona fide, knew that the trades would be reported to the public, and made no attempt to conceal any aspects of their actions.

Kellogg was decided against the regulators for good reason. The regulators' novel theory of market manipulation simply could not be squared with 35 years of Rule 10b-5 case law. Since the *Kellogg* decision was issued in 2004, no regulator has come into court and tried to make the same type of arguments that NASD/FINRA did in *Kellogg*. The Commission should not be the first.

5. *Uttering the Phrase "Enron" Or "Death Star" Does Not Magically Transform The Staff's Investigation.*

The Staff tries to compare Dr. Chen's trading to other trading practices at Enron during the Western Energy Crisis, including what it calls the "Death Star" trading strategy. Report at 47-50.[16] The Report goes out of its way to utter the phrase "Death Star" as much as possible – referring to it 11 times in the space of about three pages – as if repeating that scary-sounding phrase (as well as uttering the word "Enron" as much as possible), will smear Dr. Chen and Powhatan and convince the Commission that they did something wrong.[17]

It is noteworthy that two of the twelve experts in this matter who think Dr. Chen's trading was perfectly legal were involved with FERC's investigation of the Western Energy Markets, David Hunger and Chester Spatt. *See* Sworn Statement of David Hunger, at 1 ("Of particular relevance here, I was the lead economist in FERC's Investigation of Price Manipulation of Western Markets and Enron's impact on energy markets."); Sworn Statement of Chester S. Spatt, at 5 ("I served as an expert for the FERC in its 2002-03 investigation of the manipulation of the Western energy markets in the United States."). Therefore, the people who know that

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[16] The Report is the first time that the Staff has compared Dr. Chen's trading to anything at Enron, so it took the Staff over four years to concoct this theory.

[17] James Owens of the Staff took the Enron smear a step further during the deposition of Richard Gates, gratuitously asking him: "And then so you were aware that people went to prison as a result of the Enron trading?" Testimony of Richard J. Gates (May 7, 2012) Tr. 73:3-4.

investigation (and the dreaded "Death Star") the best do not think that Dr. Chen or Powhatan did anything wrong.

As the Report explains, the Death Star strategy allegedly involved trickery and deception. It was supposedly designed to generate payments "by 'fooling' the Cal ISO's computerized congestion management system," and could do so, for instance, because "the return leg of the Death Star transactions was scheduled on paths outside of the California ISO's control area, rendering them invisible to the ISO as a practical matter . . . ." Report at 48-49. Thus, the ISO "only sees what is happening inside its control area, so it only sees half the picture." *Id.* at 49 n.267. Dr. Chen's trading, by contrast, involved no deception whatsoever. *See, e.g.*, Sworn Statement of David Hunger, at 4 ("It is also noteworthy that there was nothing deceptive in Dr. Chen's trading behavior."); Sworn Statement of Chester S. Spatt, at 8 ("Dr. Chen and Powhatan did not attempt to hide their transactions, strategy or intent. They did not create false reports in conjunction with the trades or attempt to mislead either PJM or FERC with respect to the transactions that they undertook. Indeed, the MLSA credits provided were on a trade level basis, in accordance with the PJM tariff without any misrepresentation.").

Additionally, when commenting on the Enron trading, the Commission noted that market participants could not escape disgorgement of profits just because the Commission "did not (as, indeed, it could not) foresee all the myriad means that certain market participants could employ to the detriment of competition." Report at 50. That makes sense. But the situation here is totally different: it is not a case where the trader did something that the Commission did not (or could not) foresee. As explained in detail above, it is a case where the Commission had *actually foreseen* the type of trading at issue and chose not to prohibit it or indicate that there were any legal problems with such trading.

6. *Who Cares What Bob Steele Thinks?*

Obviously, what one individual UTC trader plucked out of thin air thinks about Dr. Chen's trades has no bearing on this case – especially if that trader has an ulterior motive for his opinion. Nevertheless, the Staff fixates on Bob Steele's comments that he thought Dr. Chen made manipulative trades. *See* Report at 31-32, 67-68. What the Staff does not point out, though, is that Mr. Steele is angry with and biased against Dr. Chen and Powhatan because he thinks they threatened to "kill the goose that laid the golden egg." Testimony of Robert Steele (Apr. 7, 2011) Tr. 169:12-13. Steele relied on UTC trading to make his living. *See id.* Tr. 171:17-18. In his words, that market gave him the "best risk/reward opportunity." *Id.* Tr. 171:24. He was concerned that, in response to trading like Dr. Chen's, the regulator would overreact and eliminate the UTC market altogether. *See id.* Tr. 169:14-18.

But even if he were not biased, who cares what Bob Steele thinks of the trading?[18] Powhatan could just as easily come up with another trader who thinks that the trading was legal – how about, for example, Bob Steele's business partner and friend, Bryan Hansen? What does the Report have to say about him? Nothing, of course. But Hansen submitted a sworn statement in which he observed that "I do not agree that [trading like Dr. Chen's] was 'rank manipulation.' As stated above, it is my opinion that it is not market manipulation to profit from flaws in the design of the energy markets." Bryan Hansen's Responses to Data Request, dated Dec. 8, 2014, Response No. 16c. He also stated that Dr. Chen and traders like him "were simply taking advantage of poorly designed market rules," and answered "No" in response to the Staff's question of whether Dr. Chen was a "bad egg." *Id.*, Response No. 16f. He further noted that the

[18] The only way Bob Steele's opinion would be relevant is if he were to serve as an expert for FERC in this matter, which is rather unlikely, to put it mildly. Twelve experts – many of whom are among the world's leading authorities on energy trading and/or market manipulation – have set forth their reasons why Powhatan and Dr. Chen have done nothing wrong. The Staff has not identified a single expert.

trades were not risk-free because "one could not know ahead of time that the [MLSA] allocation was going to be more than the total fixed cost of the Up-To Congestion transaction." *Id.*, Response No. 16a. Finally, in response to the question of whether Dr. Chen and Kevin Gates were gaming the system, he stated that:

> I am not sure the term "game" is appropriate. In my opinion, one of the functions of the financial-only market participants is to find issues with both the design of the power [] markets, and the day-to-day functioning of the power markets. ***Taking advantage of the Marginal Loss allocation issue is no different than taking advantage of a persistent mispricing of LMP nodes in the Day Ahead and Real Time Markets.*** These situations are resolved by more and more market[] participants taking advantage of the issue until the issue is resolved because it becomes uneconomical, or there are systemic changes made. *i.e.* changes to physical power grid or changes to the design of the market itself.

Id., Response No. 15a (emphasis added). Well said, Mr. Hansen.

7. *The Staff Has Not Identified Any Actionable "Harm."*

It is hard to tell what exactly the "harm" from Dr. Chen's trading is supposed to be because the Report spends hardly any time on this issue, despite its bloated, 84-page length. But it appears to say that the harm is the supposed "misallocation of over $10 million of MLSA." Report at 81.[19] The Staff's recent Answer in Opposition to Expedited Motion for Two-Week Extension of Time confirms this, as it points to a PJM MLSA Reallocation Simulation that runs

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[19] Regarding any civil penalties for the alleged harm, Powhatan objects to any joint and several liability. The Report states that "staff believes it is appropriate to hold Powhatan and HEEP jointly and severally liable for the penalties against HEEP." Report at 82. Contrary to the Staff's proposal, joint and several liability is inappropriate because civil penalties can be apportioned between Powhatan and HEEP. The Commission has stated that "[j]oint and several liability is traditionally used where activity of multiple parties creates harms that cannot be distinguished from one another and there is no reasonable basis for determining the contribution of each in the resulting harm." *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs. Into Mkts. Operated by the Cal. Indep. Sys. Operator and the Cal. Power Exch.*, Order on Reh'g, 105 F.E.R.C. ¶ 61,066 at P 170 (Oct. 16, 2003). The Commission has further recognized that "[t]here is a general preference to avoid use of joint and several liability when apportionment is possible." *Id.* at P 170, n.101. Joint and several liability has no place here because the Commission could apportion the civil penalties among the parties – in fact, the proposed penalties are already clearly delineated for each entity on the first page of the order to show cause.

the numbers on how the rebates would have been distributed, absent Dr. Chen's trades. Thus, the "market harm" (and the dollar amounts that individual companies supposedly "lost") is a function of nothing more than spreading around the rebates in a different way.[20] Staff's Answer in Opp'n. to Expedited Mot. for Two-Week Extension of Time, at 9. In other words, the supposed harm is all about how other market participants did not get their fair share of the rebate pie because Dr. Chen and Powhatan allegedly hogged too much of it.

The problem with this formulation of "harm," however, is that nobody is entitled to any particular "share" of the rebates. Dr. Chen and Powhatan were not depriving other traders of anything that the other traders were entitled to. Rather, Dr. Chen and Powhatan were entitled to the transmission loss credits that they collected based on their payment of the transmission costs and other fixed costs of the system – and the Commission itself had previously found that no entity was entitled to receive any particular amount of credits. *Black Oak Energy, LLC*, 125 F.E.R.C. ¶ 61,042 at P 12 (***"[T]he Commission reiterated that no party is entitled to receive any particular amounts through disbursement*** [of the credit that inevitably results from using the marginal line loss methodology], since the price each is paying (based on marginal line losses) is the correct marginal cost for the energy each is purchasing.") (citing *Black Oak Energy*, Order Denying Complaint, 122 F.E.R.C. ¶ 61,208 at P 46 (Mar. 6, 2008)) (emphasis added).

Thus, the Commission has already rejected the theory of "harm" that the Staff trots out here – that certain parties should have received particular rebate amounts. But the Staff is stuck with that theory because there is no way they can show that the trading here wrongfully affected prices or harmed the market in any other way.

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[20] It is both amusing and ironic that the Staff would say that the "harm" to other individual traders is that they lost out on rebate revenue when the Staff's case theory is that traders are not even allowed to pursue such revenue in the first place.

III. CONCLUSION

As we noted at the outset, the Commission has an opportunity to show true leadership and to terminate this investigation for the right reasons. This investigation has been so poorly conceived and poorly executed that it does a disservice to the Commission. If this case proceeds any further, it will be a train wreck for FERC. That serves nobody's purposes. Powhatan respectfully requests that the Commission step in here and say "no" to the Office of Enforcement and its Staff. They need to hear it.

Respectfully submitted,

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Counsel for Powhatan Energy Fund LLC

Dated: February 2, 2015

CERTIFICATE OF SERVICE

I hereby certify that on this day a copy of the foregoing response in opposition has been served upon counsel for FERC Enforcement in the above-referenced proceeding.

Dated at Philadelphia, PA, on this 2nd day of February, 2015.

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