# As its enforcement authority is clarified, FERC denies setting 'trap for the unwary'

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A recent court decision and a high-profile FERC order have offered some important insight into the breadth of that agency's authority.

**CFTC or FERC jurisdictional?**

Certain questions about that authority emerged after the U.S. Court of Appeals for the District of Columbia Circuit in March 2013 overturned a FERC order fining former Amaranth hedge fund trader Brian Hunter $30 million for manipulating natural gas futures contracts being sold on the New York Mercantile Exchange.

The U.S. Commodity Futures Trading Commission has exclusive jurisdiction over transactions involving futures contracts on CFTC-regulated exchanges, even if those contracts affect prices in FERC-jurisdictional markets, the court reasoned.

Several parties subsequently targeted by FERC enforcement officials have cited *Hunter* in claiming that their trades were also not subject to that federal agency's oversight.

For instance, Barclays Bank PLC and four former traders for the bank asserted that swap contracts that FERC found to be manipulative were essentially futures contracts. And under *Hunter*, they suggested, if a manipulative scheme involves the use of CFTC-jurisdictional contracts, the CFTC has jurisdiction over that activity even if the trades also involve physical power contracts.

But in a May 19 ruling, a judge for the U.S. District Court for the Eastern District of California found that the bank failed to show that the swap transactions at issue were futures contracts. Judge Troy Nunley also indicated that FERC's jurisdiction turns on where the alleged manipulation takes place, not the market in which the defendant may have benefited.

The judge recalled that the trader in *Hunter* sold natural gas contracts on the CFTC-regulated NYMEX futures market to benefit assets held in FERC-jurisdictional gas markets. Thus, the trading that affected physical prices involved futures contracts — and only futures contracts — that were traded on a CFTC-regulated exchange.

In contrast, the trades in *Barclays* took place on a FERC-jurisdictional market, the IntercontinentalExchange Inc., to benefit the company's swap positions in a CFTC-jurisdictional market. Moreover, the CFTC did not claim jurisdiction over the *Barclays* trades like it did the *Hunter* trades. The judge therefore found that FERC has jurisdiction over the *Barclays* trades in question.

A case involving a Powhatan Energy Fund LLC trader involved similar issues as those presented in the *Barclays* case. Houlian Chen, who traded on behalf of Powhatan and his own two funds, argued that because the alleged manipulative transactions were virtual transactions that were purely financial in nature, FERC lacked jurisdiction over them as they did not result in the physical delivery of electricity.

But in a May 29 ruling, FERC stressed that its jurisdiction over transmission "is extremely broad" and is not limited to transactions that only result in delivery of physical energy. In particular, the agency noted that virtual transactions affected the market clearing price for wholesale power and, in fact, are "integral to the operation and settlement" of wholesale electricity markets subject to its jurisdiction.

FERC also stressed that the trading took place on the FERC-jurisdictional PJM market and that the suspect trading behavior affected the amount of transmission service available to other market participants to use for their transactions,

including physical power sales. The trades also involved the reservation of jurisdictional transmission services within the PJM market.

The judge in the *Barclays* case reached similar conclusions in shooting down arguments that FERC lacked jurisdiction over the transactions at issue because they did not involve the physical delivery of electric energy. Nunley was not convinced that the *Barclays* trades were not connected to the physical transfer of electricity, noting that the markets in which the defendants traded were relied on by other market participants, including utilities and generators, to meet physical needs.

**Is FERC setting a trap for the unwary?**

On perhaps a more controversial issue, FERC found that Chen knew the purpose of the up-to-congestion trades at issue was to allow financial traders to profit by arbitraging market prices between two locations in the day-ahead and real-time market, which at the same time would benefit the PJM market by helping cause the prices in those two markets to converge.

By engaging in riskless wash trades that were designed solely to receive out-of-market transmission loss credits, FERC said Chen and the funds knew the commission and PJM would consider their strategy inappropriate or manipulative. FERC further maintained that they understood that other market participants would receive a proportionally smaller share of TLCs because of their trading scheme and that fraudulent trades could not and did not provide any "benefit to the market."

That reasoning has led to some consternation in the industry. For instance, a recent article on a Bracewell & Giuliani energy legal blog written by a couple of the firm's lawyers suggested that FERC may be placing a burden on market participants to understand the purpose behind an approved market design before trading in that market.

In other words, they concluded that FERC is saying that traders must examine whether their trades affect the market as the market designers anticipated before making those trades. "This presents major issues for compliance and trading staff of companies trading in FERC approved markets," the lawyers wrote.

But a FERC representative told SNL Energy that FERC's discussion in that regard does not create a new standard. As stated in the order, the representative explained that when determining whether someone had fair notice of a regulatory requirement, the courts have repeatedly considered whether "a reasonably prudent person familiar with the conditions that the regulations are meant to achieve [has] fair warning of what the regulations require."

The commission determined that a reasonably prudent person familiar with the conditions or purposes of PJM's market rules would have had fair warning not to engage in the sort of wash trading that was the subject of the allegations against Chen and Powhatan. Moreover, the agency determined that they "were actually familiar with those conditions and purposes and that they executed their wash trades despite knowing that such trading was incompatible with those purposes."

According to the representative, the order makes clear that FERC is not setting "a trap for the unwary." To the contrary, the representative said the evidence showed that Chen and Powhatan "knew that their manipulative trades subverted and were incompatible with the premise and purpose of allowing trade in virtual instruments" in the first place. The trades were not only wash trades but also had "no fundamental economic rationale or value," and Chen and Powhatan knew this to be so, the representative asserted.

Nunley also addressed a matter of first impression: the applicability of the term "entity" as used in the relevant section of the Federal Power Act. The statute prohibits "any entity" from using a "manipulative or deceptive device or contrivance" in connection with the purchase or sale of wholesale electric energy or transmission services, but Congress never defined "entity." The *Barclays* defendants argued that the plain meaning of the term refers to organizations, not individuals.

Nunley disagreed, reasoning that defining "entity" as including individuals "appears more consistent with the goals" of the FPA "and the surrounding statutory scheme." He also noted that other relevant enforcement provisions in the FPA apply to individuals.

Another important ruling made by the judge is that transactions made in the open market may still be misleading even if

they involve willing counterparties. FERC reached the same two conclusions in the *Powhatan* case.

**Key takeaways**

FERC continues to take a broad view of its enforcement authority, having concluded that the D.C. Circuit's decision in *Hunter* only means that it lacks jurisdiction over futures contracts exchanged on CFTC-regulated exchanges and that it can sanction individuals who engage in market manipulation. The California federal district court agreed with FERC on both those points, and it is the only court to date to have ruled on them.

In the *Powhatan* case, FERC did not say that a trader needs to be familiar with the purpose of a market and its rules. However, if a trader does understand the design and purpose behind a market, the commission made clear that the trader needs to transact in a manner that is consistent with that purpose.

FERC made several other key rulings in the *Powhatan* case, including that actions taken in the open market that broke no market rules can still be inherently misleading and manipulative, and the 4-0 vote by the commissioners for that order indicates that the commissioners believe that the case staff built is on solid legal ground. That has not always been the case in the past, as several commissioners have voiced concerns over certain technical legal matters in voting on enforcement orders.

However, the *Powhatan* case is now most likely headed to a federal district court, which will review the case de novo because Powhatan has said it will not settle the matter or pay the ordered amounts. While the exact scope of a de novo review is still under debate, one thing that is clear is that the court is under no obligation to defer to FERC's legal positions.

Moreover, the California federal district court has yet to rule on the merits of the *Barclays* case, and the judge's preliminary legal findings are precedential only in the Eastern District of California. Nevertheless, unless and until another court tells FERC to stop doing so, it seems the agency will continue to take a broad view of its enforcement authority.

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