

FERC's Market Manipulation Investigatory and Enforcement Process

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The authors explain that FERC's market manipulation regulations greatly expand the Commission's enforcement authority and subject previously unregulated entities to FERC jurisdiction. They add that financial service companies and others whose activities might affect the power and gas markets are subject to monitoring and potential investigation.

The Energy Policy Act of 2005 ("EPAAct") expanded the authority of the Federal Energy Regulatory Commission ("FERC") to pursue civil penalty actions for so-called "market manipulation" in power and gas markets, as well as certain transmission and transportation service markets. Before passage of EPAAct, FERC's enforcement authority extended only to regulated entities, such as electric utilities, oil and gas pipelines, natural gas distributors, and certain financial service companies registered as power marketers with FERC. FERC now interprets its authority as extending to any entity whose alleged manipulative or deceptive conduct directly or indirectly affects the markets over which it traditionally has had jurisdiction. Thus, FERC actively monitors unregulated financial markets to determine whether they might *affect* markets such as wholesale electricity sales and certain natural gas sales that FERC does regulate.¹ Entities that have never dealt with FERC have found themselves under investigation and, in some instances, exposed to multi-million dollar penalties.

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FERC'S AUTHORITY

The EAct made it unlawful for “any entity” to use a “manipulative or deceptive device or contrivance” “in connection with” the purchase or sale of natural gas or electric energy or the purchase or sale of transportation or transmission services that are subject to FERC jurisdiction.² The Act provides that the term “manipulative or deceptive device or contrivance” is used “as those terms are used in section 10(b) of the Securities Exchange Act of 1934.”³ Consistent with that direction, FERC adopted rules governing gas and power markets modeled on the Securities Exchange Commission (“SEC”) Rule 10b-5:

- (a) It shall be unlawful for any entity, directly or indirectly, in connection with the purchase or sale of [natural gas/electricity] or the purchase or sale of [transportation/transmission] services subject to the jurisdiction of the Commission,
 - (1) To use or employ any device, scheme, or artifice to defraud,
 - (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 - (3) To engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity.⁴

FERC exercises its authority under these regulations consistent with the SEC’s enforcement of Section 10(b), including reading the SEC’s scienter requirement into the regulations.⁵ Thus, an entity violates FERC’s market manipulation rules if it acts either intentionally or *recklessly* to deceive or defraud any entity in connection with a jurisdictional transaction.⁶ EAct increased maximum civil penalties for market manipulation and other violations to \$1 million per day/per violation, in addition to disgorgement of unjust profits.⁷

Any entity can be subject to the market manipulation prohibition, regardless of whether it has previously been subject to FERC jurisdiction. For example, local distribution companies and municipal utilities that were

not previously regulated by FERC but whose activities impact FERC-jurisdictional transactions are subject to the rule. Targets of the market manipulation authority include financial traders whose activities in the futures markets can impact the prices charged in regulated energy markets.

OPENING AN INVESTIGATION

An initial investigation into alleged market manipulation can be touched off by several different events. FERC's Division of Energy Market Oversight ("DEMO"), for instance, monitors the electric, natural gas and related energy and financial markets daily for competitiveness, fairness and efficiency, providing information for potential investigations.⁸ Investigations can also originate from complaints from customers, competitors and other entities. FERC issued a Revised Policy Statement in May 2009 reflecting enforcement experiences. The Revised Policy Statement filled a gap in a 2005 Policy Statement by listing the criteria FERC's staff would consider when deciding whether to open an investigation:

- the nature of seriousness of the alleged violation
- the nature and extent of the harm
- the efforts made to remedy the alleged violation
- whether the alleged violations were widespread or isolated
- whether the alleged violations were willful or inadvertent
- the importance of documenting and remedying the potential violations to advance FERC policy objectives
- the likelihood of the conduct recurring
- the amount of detail in the allegation or suspicion of wrongdoing
- the likelihood that FERC staff could assemble a legally and factually sufficient case
- the compliance history of the alleged wrongdoer
- FERC staff resources.⁹

Informal Investigation

After learning of a potential violation, FERC can conduct two types of investigations — preliminary and formal. In practice, however, nearly all FERC investigations begin as preliminary — that is, informal, non-public — investigations.¹⁰ The staff's powers in a preliminary investigation are limited. At this stage it lacks subpoena authority and, therefore, cannot compel a target or third party to provide testimony or documents. Instead the staff relies on voluntary requests for information. Typically, these requests are made by letter to the target itself or to third parties, and often the letter includes both interrogatory-style questions and requests for documents. These letters also usually include an instruction to preserve all documents that might be relevant to the staff's inquiry. The demand to preserve documents could thus be far broader in scope than the document request itself. Although it lacks the ability to subpoena witnesses for deposition at this stage, FERC staff frequently requests and obtains both informal interviews and formal depositions under oath of witnesses during a preliminary investigation. In addition to this voluntary discovery, the staff relies on its own market observations, publicly available data, data obtained from other government agencies, and any information obtained from regulated entities through required filings.¹¹

Following a preliminary fact-finding phase, enforcement staff develops an opinion regarding whether the investigation should either be terminated or continued. If staff believes a violation might have occurred, it seeks authorization from the Director of the Office of Enforcement to provide a letter to the subject that sets forth staff's preliminary findings and the facts and reasons in support of the findings. The subject may then respond to the preliminary findings letter setting forth challenges and rebuttal evidence. Based on the subject's response, staff may re-evaluate its analysis, modify its allegations, or take other action, such as seeking authorization from the Commission to commence settlement discussions and to attempt to obtain remedies and/or sanctions for the alleged violations.¹²

In December 2009, FERC issued an Order requiring public disclosure of a "Staff's Preliminary Notice of Violations" upon direction from the Director of the Office of Enforcement. The Order provides that public notice shall be issued "after staff has informed the subject that staff preliminarily

determined from its investigation that one or more violations of applicable rules, regulations, statutes or orders may have occurred and the subject of the investigation has had an opportunity to respond to staff's preliminary findings letter. That Notice shall disclose (1) the identity of the entity or entities that are the subject of the investigation; (2) the time and the place of the alleged conduct; (3) the rules, regulations, statutes or orders that staff alleges were violated; and (4) a concise description of the alleged wrongful conduct."¹³

In the event staff decides to terminate an investigation after such a preliminary notice of violations has been issued, a public notice of termination would be issued. Generally in the past, no public notice of an investigation was issued until either the investigation was resolved through a settlement or the Commission had issued a formal Order to Show Cause. According to FERC, the new policy of public disclosure after a subject has had an opportunity to rebut staff's preliminary findings letter "balances the need to protect the subject's confidentiality in the early stages of an investigation with the public interest of promoting additional transparency during investigations."¹⁴

Formal Investigation

The Commission, at its discretion, can convert a preliminary investigation into a formal investigation by issuing an Order of Investigation, outlining the scope of the inquiry and the specific authority of the investigating officers. Under FERC regulations, officers conducting formal investigations have the power to subpoena witnesses, compel testimony and require the productions of documents or other relevant evidence.¹⁵

If a subject believes that FERC is abusing its investigative power, it can refuse to respond to a FERC subpoena. Although non-final administrative orders such as subpoenas are not reviewable by a district court, these orders are also not self-executing.¹⁶ If a party refused to comply, FERC's only remedy would be to seek enforcement in federal court — thereby affording the subpoena recipient an opportunity to contest the validity of the subpoena.¹⁷ Willful refusal to comply with a FERC subpoena is punishable as a misdemeanor,¹⁸ but good faith challenges to FERC's authority are protected.¹⁹ In practice, challenges to administrative subpoenas are rarely

successful as district courts are reluctant to second-guess administrative agencies' investigative authority.²⁰

INVESTIGATORY PROCESS

Communication with the Commission

FERC allows a party subject to an informal investigation to communicate, in writing only, with Commissioners or decisional staff to furnish relevant evidence and explain the party's position before any formal proceeding is initiated. Order No. 718 revised FERC regulations governing *ex parte* contacts and the separation of functions between enforcement and other Commission staff.²¹ First, the Order clarified that intervention by third parties in non-public investigations initiated under Part 1b of FERC regulations²² is not available as a matter or right. Second, FERC revised the rule to provide that, before a formal proceeding is initiated, a company being investigated could communicate with Commissioners or decisional staff in writing but not in person or by phone. The Order provides that, once a formal proceeding in connection with a Part 1b investigation has been initiated, neither outside persons nor FERC enforcement staff may engage in off-the-record communications with Commissioners or their staff.

Discovery

During FERC's fact-gathering process, staff generally maintains frequent contact with the subject under investigation and will meet with company representatives to discuss relevant information.²³ Despite requests, FERC has declined to establish a mediation process to address discovery disputes that may arise during an investigation.²⁴

In practice, much of the discovery conducted by FERC staff happens during the preliminary investigative phase. In its 15 month investigation of Amaranth Advisors LLC, for example, FERC staff received from both Amaranth and third parties trade and position data, memoranda, reports, emails, instant messages, and telephone tape recordings, and took sworn testimony from more than 15 witnesses.²⁵

Although all of the discovery conducted during the preliminary stage

is voluntary, companies have incentives to cooperate with the staff during this phase of the investigation. The Commission can convert a preliminary investigation into a formal one at its discretion — thereby granting investigative staff the subpoena power necessary to enforce any discovery requests, which might result in substantially increased discovery burdens. A target might also calculate that by cooperating with FERC, counsel can more readily engage FERC staff — learning valuable information about the scope of the investigation and FERC's concerns. These conversations present opportunities to narrow the scope of the discovery requests, influence the staff's thinking about the case, and possibly resolve the issue early or at least narrow the scope of the matter. In addition, as discussed below, cooperation is an important factor in mitigating penalties.

In December 2009, FERC also joined certain other enforcement agencies such as the Securities and Exchange Commission and the Commodity Futures Trading Commission by requiring *Brady*-type disclosures²⁶ by enforcement staff in administrative proceedings.²⁷ The new policy formalizes what had been an undefined informal practice in past proceedings. During an investigation, staff is now directed to scrutinize materials it receives from sources other than the subject for information that would be required to be disclosed under *Brady*. "Any such materials or information that are not known to be in the subject's possession shall be provided to the subject."²⁸ If the investigation later moves to a formal proceeding before an Administrative Law Judge, staff must provide an affidavit to the ALJ stating it has complied with this policy. Respondents may also file a motion with the ALJ if they believe exculpatory evidence has not been disclosed.²⁹

Settlement

If the FERC staff believes sanctions are appropriate, it will attempt to reach a settlement with the subject of an investigation before recommending an enforcement proceeding.³⁰ FERC will consider the staff's views and the subject's written response when considering whether to grant settlement authority to the staff. Following a grant of settlement authority, staff and the subject conduct settlement negotiations, which might involve

several meetings. In some cases, FERC staff will draft a proposed stipulation and consent agreement as the basis for negotiations. Staff will submit a final agreement for FERC's approval. If approved by the Commission, the settlement agreement will generally be released publicly.³¹

Orders to Show Cause

If staff and the subject of an investigation cannot reach a settlement agreement, staff may recommend that FERC initiate enforcement proceedings through an Order to Show Cause. In most cases, the staff will notify the subject of its intention to make this recommendation, and the subject will have the opportunity to deliver a response to the Commission.³² Following the issuance of an Order to Show Cause, settlement may occur in accordance with Rule 602 of FERC's Rules of Practice and Procedure, under which any participant in the proceedings may submit an offer of settlement at any time.³³ If the Commission approves the settlement, the investigation closes. If there is no settlement, the proceeding will continue according to the hearing process prescribed in the Natural Gas Act, Natural Gas Policy Act or Federal Power Act depending on the nature of the alleged violation.³⁴

REMEDIES

If FERC identifies a violation of a governing statute, regulation, or order, it has broad discretion in determining an appropriate remedy.³⁵ Remedies include disgorgement, compliance plans, and civil penalties.

Disgorgement of Unjust Profits

If a party acquires unjust profits through a violation of a statute, regulation, or order, the Commission has discretion to order disgorgement — and it may order this remedy in addition to civil penalties or other remedies.³⁶ In *In re SCANA Corporation*, for example, FERC ordered the disgorgement of \$1.4 million in unjust profits for the improper use of a network transmission service, as well as a \$9 million civil penalty.³⁷

Compliance Plans

Most of the settlements FERC has imposed after EAct have included compliance plans in addition to other remedies.³⁸ Under the compliance plan, a party must submit sworn reports to FERC staff on a periodic basis, most typically semi-annual reports for one to three years. The reports describe company measures to end its practices that led to the violations and alert FERC staff to additional violations that may have occurred. For frequent violators or parties without a compliance culture, FERC may also require a comprehensive compliance program, which could involve the engagement of an independent consultant.³⁹

Civil Penalties

Under EAct, FERC can impose civil penalties of up to \$1 million per day, per violation. Although FERC has stated that it will not create a schedule of specific penalties, it has provided insight into the factors it will consider in assessing fines under this new enforcement authority, including the seriousness of the violation, the company's culture of compliance, and the company's level of cooperation and self-reporting.

The most valuable mitigating factor may be a company's initiative to self-report a violation. FERC has stated that prompt self-reporting, combined with corrective measures "may result in a significant reduction in the amount of civil penalty *or no civil penalty being assessed*."⁴⁰ This does not create a formal amnesty program, like that familiar to antitrust practitioners; however, it appears clear that FERC will consider self-reporting a significant factor in penalty assessment, and the benefit of doing so should be weighed carefully by any entity that discovers a possible violation.

In its Revised Policy Statement of May 2008, FERC described six new factors evaluating the seriousness of a violation for civil penalty purposes:

- What, if any, harm was there to the efficient and transparent functioning of the market?
- What are the earnings, revenues, and market share of the part of the company that is under investigation?

- What penalty amount best discourages improper conduct while not excessively discouraging beneficial market participation?
- What was the motivation of those accused of improper conduct?
- Was the integrity of the regulatory process impaired?⁴¹

In a follow-up October 16, 2008 Policy Statement on Compliance, FERC noted that if a company has acted aggressively to develop a compliance program that provides effective accountability for enforcement, but a violation nevertheless occurs, then the Commission might reduce or, for nonserious violations, even eliminate civil penalties. FERC set forth four factors it would take into account:

- (1) the role of senior management in fostering compliance;
- (2) whether the company has effective preventative measures in place to ensure compliance;
- (3) the prompt detection, cessation, and self-reporting of violations; and
- (4) any remedial efforts.⁴²

CONCLUSION

FERC's market manipulation regulations greatly expand the Commission's enforcement authority and subject previously unregulated entities to FERC jurisdiction. The potential penalties are extremely steep. Financial service companies and others whose activities might affect the power and gas markets are subject to monitoring and potential investigation.

NOTES

¹ For example, "first sales" and retail sales of natural gas are generally exempted from FERC jurisdiction. Activities related to hydropower would also be covered by the new market manipulation rules to the extent they involve or impact electricity transactions under FERC jurisdiction.

² 15 U.S.C. § 717c-1; 16 U.S.C. § 824v(a) (2007).

³ 15 U.S.C. § 717c-1; 16 U.S.C. § 824v(a). *See generally* Securities Exchange

Act of 1934, 15 U.S.C. § 78 et seq. (2007).

⁴ 18 C.F.R. §§ 1c.1, 1c.2 (2007).

⁵ FERC's Order No. 670 (essentially the preamble to the above rule) provides: The Commission will act in cases where an entity: (1) Uses a fraudulent device, scheme or artifice, or makes a material misrepresentation or a material omission as to which there is a duty to speak under a Commission-filed tariff, Commission order, rule or regulation, or engages in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) *with the requisite scienter*; (3) in connection with the purchase or sale of natural gas or electric energy or transportation of natural gas or transmission of electric energy subject to the jurisdiction of the Commission.

Prohibition of Energy Market Manipulation, 114 FERC ¶ 61,047 (Jan. 19, 2006) ¶ 49 (emphasis added).

⁶ *Id.* ¶ 53.

⁷ See 15 U.S.C. § 717t-1(a); 16 U.S.C. § 825o-1(b).

⁸ See FERC Office of Enforcement: Division of Energy Market Oversight, <http://www.ferc.gov/about/offices/oe/oe-doemo.asp>.

⁹ Revised Policy Statement on Enforcement, 123 FERC ¶ 61,156 (May 15, 2008) ¶ 25.

¹⁰ Letter from FERC Chairman Joseph T. Kelliher to Sen. Jeff Bingaman, Chairman, Committee on Energy and Natural Resources, U.S. Senate (Feb. 21, 2007) (available at <http://www.ferc.gov/legal/ceii-foia/foia/freq-req/04-16-07.pdf>).

¹¹ See, e.g., 15 U.S.C. § 717g(b) (granting the Commissions authority to inspect all accounts, records, and memoranda of natural-gas companies).

¹² This process is discussed in greater detail in the Revised Policy Statement on Enforcement. Enforcement of Statutes, Regulations and Orders, 123 FERC ¶ 61,156 P 23-32 (2008).

¹³ 129 FERC §61,247.

¹⁴ *Id.*

¹⁵ 18 C.F.R. § 1b.13.

¹⁶ *Belle Fourche Pipeline Co. v. United States*, 751 F.2d 332, 334 (10th Cir. 1984).

¹⁷ 15 U.S.C. § 717m(d); 16 U.S.C. § 825f(c).

¹⁸ *Id.*

¹⁹ *Fed. Power Comm'n v. Metropolitan Edison Co.*, 304 U.S. 375, 387 (1938).

²⁰ See, e.g., *Sandsend Fin.l Consultants, Ltd. v. Fed. Home Loan Bank Bd.*,

878 F.2d 875, 878 (5th Cir. 1989) (“[A]n administrative agency’s power to issue subpoenas as it performs its investigatory function is a broad-ranging one which courts are reluctant to trammel.”).

²¹ Ex Parte Contacts and Separation of Functions, 125 FERC ¶ 61,063 (2008).

²² 18 C.F.R. Part 1b (2008).

²³ Revised Policy Statement on Enforcement, 123 FERC ¶ 61,156 (May 15, 2008) ¶ 28.

²⁴ *Id.* ¶ 30.

²⁵ Amaranth Show Cause Order, ¶ 53.

²⁶ In *Brady v. Maryland*, 373 U.S. 83, 88 (1963), the Supreme Court held that criminal defendants have a due process right to receive exculpatory evidence “material to guilt or punishment” known to the government but unknown to defendants.

²⁷ “Policy Statement on Disclosure of Exculpatory Materials,” 129 FERC ¶ 61,248 (Dec. 17, 2009).

²⁸ *Id.* ¶ 9.

²⁹ *Id.* ¶ 12.

³⁰ Revised Policy Statement on Enforcement, 123 FERC ¶ 61,156 (May 15, 2008) ¶ 33.

³¹ *Id.* ¶ 34.

³² *Id.* ¶ 35.

³³ 18 C.F.R. section 385.602(b) (2007).

³⁴ Revised Policy Statement on Enforcement, 123 FERC ¶ 61,156 (May 15, 2008) ¶ 39.

³⁵ *Id.* ¶ 41.

³⁶ *Id.* ¶ 42.

³⁷ *In re SCANA Corp.*, 118 FERC ¶ 61,028 (Jan. 18, 2007).

³⁸ Revised Policy Statement on Enforcement, 123 FERC ¶ 61,156 (May 15, 2008) ¶ 44.

³⁹ *Id.* ¶ 46.

⁴⁰ Policy Statement on Enforcement, 113 FERC ¶ 61,068 (Oct. 20, 2005) ¶ 25 (emphasis added).

⁴¹ Revised Policy Statement on Enforcement, 123 FERC ¶ 61,156 (May 15, 2008) ¶ 56.

⁴² Policy Statement on Compliance, 125 FERC ¶ 61,058 (Oct. 16, 2008) ¶¶ 1-2.