

Market Manipulation Staying a Step Ahead

Law, compliance, and case management –
plus the blurred boundary between FERC and CFTC.

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The U.S. Federal Energy Regulatory Commission (FERC or Commission) has made policing against fraud and manipulation in energy markets one of its highest priorities. In the aftermath of the western energy crisis of 2000-2001, Congress provided FERC with broad civil penalty authority and the power both to monitor physical energy markets and prohibit market manipulation. FERC can impose penalties of up to \$1 million per market manipulation violation per day.¹

Between 2007 and the end of 2014, excluding overturned or pending matters, FERC assessed civil penalties of \$602 million and ordered disgorgement totaling almost \$300 million.² The FERC Office of Enforcement has announced that enforcing the rule against fraud and market manipulation will continue to be a priority during 2015.³

Given the possibility of multimillion dollar penalties for violations, this article will touch on four distinct areas:

Case Law. Provide background on FERC's evolving market manipulation law and explain legal risks and exposure, including the Securities and Exchange Commission (SEC) case law precedent on which FERC relies;

Compliance Tips. Offer practical compliance tips for businesses, boards of directors and managers for minimizing the risk of FERC market manipulation allegations;

Jurisdictional Conflicts. Discuss the ongoing jurisdictional ambiguity between FERC and the Commodities Future Trading Commission (CFTC), with ramifications for persons targeted by a FERC investigation; and

How to Respond. Explain what to do should FERC or the CFTC initiate an investigation.

1. 16 U.S.C. § 825o-1 (2014).
2. FERC Staff, 2014 Report on Enforcement, Docket No. AD07-13-008, at 6, footnote omitted (Nov. 20, 2014) (Enforcement Staff Report 2014), <http://www.ferc.gov/legal/staff-reports/2014/11-20-14-enforcement.pdf>.
3. Enforcement Staff Report 2014 at 2.
4. Energy Policy Act of 2005, Public Law 109-58, §§ 315 and 1283 (Aug. 8, 2005) (adding Natural Gas Act § 4A, 15 U.S.C. 717c-1 (2014), and Federal Power Act §222, 16 U.S.C. § 824v (market manipulation provisions); and amending Natural Gas Act §§ 21 and 22, 15 U.S.C. §§ 717t and 717t-1, and Natural Gas Policy Act § 504, 15 U.S.C. § 3414 (civil and criminal penalty provisions)).
5. 15 U.S.C. § 717c-1.
6. Codified at 15 U.S.C. § 78j(b).
7. 17 C.F.R. § 240.10b-5 (2014).
8. *Prohibition of Energy Market Manipulation*, 114 FERC ¶ 61,047 at P 50 (2006) (*Market Manipulation Rule*).
9. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (*Hochfelder*).
10. *Id.* at 193.
11. *IBEW Joint Pension Trust v. JP Morgan Chase Co.*, 553 F.3d 187, 198 (2d Cir. 2009); *Fl. St. Board of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 653-54 (8th Cir. 2001) (*Fl. St. Board*).
12. *Market Manipulation Rule*, 114 FERC ¶ 61,047 at P 53 n.109.

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The universe of prohibited acts is broad, but it is still possible to reduce the risk.

The Case Law

FERC has broad power to prevent market manipulation. The Energy Policy Act of 2005 (EPAAct) amended both the Natural Gas Act and the Federal Power Act and gave FERC new authority to prohibit market manipulation and impose civil penalties for violations.⁴ Pursuant to these amended statutes, FERC prohibits “any manipulative or deceptive device or contrivance (as those terms are used in section 10(b) of the Securities Exchange Act of 1934)” in connection with a physical sale or transmission of natural gas or electricity subject to FERC’s jurisdiction.⁵

Patterned after the Securities Exchange Act section 10(b)⁶ and SEC Rule 10b-5,⁷ FERC’s market manipulation rule provides the Commission with broad anti-fraud authority.⁸ For a prohibited activity to constitute market manipulation, FERC must show that the actor possessed the requisite state of mind and establish a connection between the alleged manipulative action and an interstate transportation or sale for resale of natural gas or electricity (*i.e.*, a FERC-regulated transaction).

Consistent with Securities Exchange Act section 10(b) precedent, courts examining the requisite state of mind have interpreted the relevant statutory language to require willful conduct involving *scienter*.⁹ Section 10(b) cases make clear that *scienter* can mean intent to deceive, manipulate, or defraud,¹⁰ but also that recklessness can satisfy the *scienter* requirement.¹¹ Definitions of recklessness by various U.S. Circuit Courts of Appeal differ.¹² Generally, however, recklessness requires more

than negligence,¹³ and evidence of motive and opportunity to commit fraud or conscious misconduct can raise a strong inference of recklessness.¹⁴

The entity whose conduct is at issue does not itself have to be subject to FERC's natural gas or electricity regulation to be connected to a FERC-regulated transaction.¹⁵ A challenged entity's actions must only intentionally or recklessly *affect* a FERC-jurisdictional activity.¹⁶ To identify whether the required nexus with a FERC-regulated agreement or activity exists, FERC will look to both the connection with a FERC-jurisdictional activity and the evidence of intent, knowledge or recklessness.¹⁷ FERC has found paper mills, retail electric utilities, energy service consultants, banks and commodity traders, all of whom were otherwise not subject to FERC's jurisdiction, to have engaged in market manipulation.

A common example of market manipulation is where businesses and individuals have intentionally provided false information about the quantity of electricity purchased or amount of electric generation available to sell under FERC-regulated programs. Another example is where an entity's activities in energy markets, such as the purchase, sale or interstate transmission of natural gas or electricity, are not justified by normal market fundamentals and distort the price of energy in those markets, or the price in another market, to the benefit of the entity who took the action.

Compliance – A First Defense

In 2014 Congressional testimony, FERC Commissioner Norman Bay, who was the head of FERC's enforcement arm at the time, explained that the Commission expects all participants in FERC-regulated markets "to have good compliance programs, transact in a manner that follows market rules in letter and spirit, work cooperatively with grid operators and the Commission when there are concerns, and self-report potential violations."¹⁸

Having an effective compliance program is an essential element – a first defense – to protect against market manipulation claims. Although the universe of prohibited actions is broad, a company can, through its compliance training, significantly reduce the risk of a market manipulation claim.

Prohibited Behavior. The types of behavior prohibited under

the pre-EPAAct market behavior rules continue to constitute a valuable list of prohibited activities that an effective compliance program should specifically address. Although the current market manipulation rule is broader than the pre-EPAAct market behavior rules, FERC has made clear that the specific types of behavior that its prior market behavior rules had prohibited remain covered under the new market manipulation authority.¹⁹ Thus, FERC continues to prohibit:

- wash trades;
- transactions predicated on submitting false information;
- transactions creating and relieving artificial congestions; and
- collusion.²⁰

"Wash trades" are "pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership."²¹ Wash trades generally consist of buying and selling electricity or natural gas in an offsetting way so that the trader essentially ends up

selling and buying quantities at no economic risk, where the increased trading activity distorts the real supply and/or demand and influences the price of the traded energy.

The prohibition on "transactions predicated on false information" captures a variety of activities and practices. FERC has found evidence of this kind of manipulation in a number of cases involving demand response programs. Demand response programs generally treat an end user's commitment to cut

Market manipulation implies intent to deceive, manipulate, or defraud, but mere recklessness can suffice.

back its electricity purchases during periods of high electricity consumption as a surrogate for electric generation, and the utility or regional electric transmission organization, which relies on the reduced consumption instead of the purchase of power to balance electricity loads on its system, provides compensation to the end user for the reduced consumption.

For example, FERC has found market manipulation where businesses or individuals have misrepresented electric generation available for supply, or historical electricity purchase quantities,

13. See, e.g. *Fl. St. Board*, 270 F.3d 645, 654.

14. *Market Manipulation Rule*, 114 FERC ¶ 61,047 at P 53 and cases cited in note 109.

15. *Id.* at PP 16, 18.

16. *Id.* at P 22.

17. *Id.*

18. "Testimony of Norman C. Bay, Director, Office of Enforcement, Federal Energy Regulatory Commission, Before Committee on Banking Financial Institutions and Consumer Protection Subcommittee, U.S. Senate, Jan. 15, 2014 (2014 Bay Senate Testimony).

19. *Amendments to Codes of Conduct for Unbundled Sales Service and for Persons Holding Blanket Marketing Certificates*, Order No. 673, Docket No. RM06-5-000, 114 FERC ¶ 61,166 at P 19 (Feb. 16, 2006) (Order No. 673); *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 114 FERC ¶ 61,165 at P 24 (2006) (*Order Revising Market-Based Tariffs*), *reh'g denied*, 115 FERC ¶ 61,053 (2006).

20. *Id.*

21. *18 C.F.R. Part 284, Amendments to Blanket Sales Certificates*, Order No. 644, 105 FERC ¶ 61,217 at PP 53-54 (2003) (Order No. 644), *reh'g denied*, 107 FERC ¶ 61,174 at PP 49-53 (2003), *modified by Order No. 673*, 114 FERC ¶ 61,166.

upon which to measure purchase reductions for wholesale demand response programs.²²

In addition, persons who intentionally report false natural gas or electricity prices to price index publishers, the entities that publish commodity prices used to set contract prices under numerous physical and financial trades, can be found to violate the FERC's market manipulation rule and also may violate FERC rules that expressly cover false reporting to price index publishers.²³

"Transactions that create and relieve artificial congestions" refers to buying or selling electricity or natural gas to artificially show transmission constraints. It is similar to wash trading in that it consists of physical trading in a way that distorts market information and artificially drives the price of the physical commodity, electricity or natural gas, or some other tradable commodity, such as the rights to electric transmission. Unlike wash trades, the trading activity may not be offsetting or without economic risk.

Lastly, collusion is market manipulation by more than one party,²⁴ and covers manipulation of market prices, market conditions or market rules by more than one person or entity acting together.²⁵

In addition to the above activities, which are prohibited by both the former market behavior rules and the post-EPAAct market manipulation rule, training employees to steer clear of transactions that do not have a legitimate business purpose will help deter obvious kinds of manipulation.

In adopting the current market manipulation rule, FERC rejected requests that it establish "a legitimate business purpose" affirmative defense.²⁶ Notwithstanding that decision, FERC continues to consider the existence or not of a legitimate business purpose when evaluating alleged market manipulation. Simply trying to maximize corporate profit does not itself establish a legitimate business purpose, and manipulation can exist even if the person or business has a legitimate business purpose. Nevertheless, the absence of a legitimate business purpose can provide evidence of manipulation, and FERC's ramped-up enforcement effort relies in part on data analytics and market screens to

identify transactions not supported by market fundamentals.

During fiscal years 2011 through 2014, the Commission took fifteen final actions in which it found market manipulation, either approving a settlement or issuing a merits order. Of the fifteen actions, six involved intentionally submitting false information (or failing to report accurate information, such as electric generation or electricity use) under FERC-approved tariff programs, including demand response programs, to inflate compensation;²⁷ five involved some scheme to use physical trades of natural gas or electricity to receive unjustified compensation or profit for or in connection with a tariff right or service, such as the right to use electric transmission;²⁸ and three involved the use of physical trades of natural gas or electricity to influence

Dodd-Frank exempts simple contracts for future physical delivery, yet some forward sales can look like a swap – invoking CFTC jurisdiction.

the market price to benefit financial positions tied to the same market.²⁹ The remaining case was dismissed by the D.C. Court of Appeals finding that FERC had lacked jurisdiction.

reporting and record keeping requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act" or "Dodd-Frank"). As a general matter, FERC has jurisdiction over alleged manipulation in physical energy markets that it regulates, as well as devices or practices that affect those physical energy markets, while the CFTC has jurisdiction over alleged manipulation of the financial markets it regulates. Because numerous transactions involve both physical energy and financial markets, the question of agency jurisdiction has generated controversy.

By way of background, FERC has jurisdiction over the interstate transportation of electricity and natural gas and

the market price to benefit financial positions tied to the same market.²⁹ The remaining case was dismissed by the D.C. Court of Appeals finding that FERC had lacked jurisdiction.

Jurisdictional Ambiguities

FERC compliance programs almost always include some component of CFTC training for participants in energy markets due to the increased

22. *Lincoln Paper and Tissue*, 144 FERC ¶ 61,162 (2013) (*Lincoln*); *Competitive Energy Services*, 144 FERC ¶ 61,163 (2013) (*Energy Services*); *Richard Silkman*, 144 FERC ¶ 61,164 (2013) (*Silkman*).

23. See, e.g. *Order No. 673*, 114 FERC ¶ 61,166 at P 29; 18 C.F.R. §§ 35.41(c), 284.288(a), 284.403 (a).

24. *Order No. 644*, 105 FERC ¶ 61,217 at PP 58, 62, *reh'g denied*, 107 FERC ¶ 61,174 at PP 49-53, *modified by Order No. 673*, 114 FERC ¶ 61,166; and *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 FERC ¶ 61,218 at PP 85-92 (2003), *reh'g denied*, 107 FERC ¶ 61,175 at PP 89-90 (2004), *modified by Order Revising Market-Based Tariffs* at P 24, *reh'g denied*, 115 FERC ¶ 61,053 at P 24.

25. *Id.*

26. See, e.g. *Order 673*, 114 FERC ¶ 61,166 at P 24; *Order Revising Market-Based Tariffs*, 114 FERC ¶ 61,165 at P 29.

27. *Lincoln*, 144 FERC ¶ 61,162; *Energy Services*, 144 FERC ¶ 61,163; *Silkman*, 144 FERC ¶ 61,164; *Rumford Paper Co.*, 142 FERC ¶ 61,218 (2013); *In re Joseph Polidoro*, 138 FERC ¶ 61,018 (2012); *In re Holyoke Gas & Electric Dept.*, 137 FERC ¶ 61,159 (2011).

28. *In re Make-Whole Payments and Related Bidding Strategies*, 144 FERC ¶ 61,068 (2013); *In re PJM Up-to Congestion Transactions*, 142 FERC ¶ 61,088 (2013); *Deutsche Bank Energy Trading, LLC*, 142 FERC ¶ 61,056 (2013); *Gila River Power, LLC*, 141 FERC ¶ 61,136 (2012); *Constellation Energy Commodities Group, Inc.*, 138 FERC ¶ 61,168 (2012).

29. *Direct Energy Services, LLC*, 148 FERC ¶ 61,114 (2014); *MISO Virtual and FTR Trading*, 146 FERC ¶ 61,072 (2014); *Barclays Bank PLC*, 144 FERC ¶ 61,041 (2013).

the sales for resale (*i.e.*, wholesales) of electricity and natural gas, as well as certain other activities of electric utilities and natural gas pipelines whose transportation or sales fall within FERC's jurisdiction.

In contrast, the CFTC has jurisdiction over financial transactions, and the CFTC's jurisdiction has expanded after the global financial collapse of 2008, which led to the Dodd-Frank Act. Dodd-Frank increased the scope of the CFTC's jurisdiction to include swaps, a broadly defined term that generally covers any agreement to exchange value and which contains some tradable "optionality."³⁰

Even after the Dodd-Frank Act, the CFTC does not have jurisdiction over contracts that simply provide for the future physical delivery of a set quantity of natural gas or electricity at a set price, *i.e.*, "a forward contract." Yet, some sales of electricity and natural gas that evidence characteristics of a forward contract can still meet the broad definition of swaps under CFTC jurisdiction because they give the seller or buyer rights to adjust the purchase quantity.

The CFTC has worked to establish and clarify the forward contract exception.³¹ It also has established regulations that expand the "trade option exemption," which provides fewer reporting requirements for parties to energy contracts that do not meet the forward contract exception but whose contracts primarily involve the purchase and sale of energy as part of their traditional business use, such as a local natural gas distribution or industrial use.³²

FERC's jurisdiction regarding market manipulation that affects *solely* physical energy markets seems clear. Similarly, the CFTC's exclusive jurisdiction regarding market manipulation that affects *solely* financial transactions seems clear.³³ But jurisdictional ambiguity remains where the alleged manipulation involves both the physical energy and related financial markets.³⁴

Yet, FERC has made it clear that it will continue to investigate alleged cross-over manipulation where the actor manipulates

natural gas or electricity markets to influence the price of and benefit positions in financial instruments. For example, in May 2014, FERC set for hearing before an administrative law judge (ALJ) questions of alleged market manipulation by BP America, Inc., and its affiliates.³⁵ FERC claimed that BP's traders transported natural gas from the Katy market hub to the Houston Ship Channel market hub and sold gas at the Houston Ship Channel in a way that would influence, and with the intent of influencing, the Houston Ship Channel natural gas price index as part of a scheme to benefit BP's natural gas swap positions.

In situations where FERC and the CFTC each claim jurisdiction, the business or individual involved in the investigation will have to deal with different processes and standards. As a general matter, the CFTC's new market manipulation power added by Dodd-Frank is similar to FERC's except that the CFTC's statute provides a good faith defense for false reporting.³⁶ Moreover, Dodd-Frank preserved the CFTC's prior market

FERC's authority seems clear over purely physical sales, yet it will look also at 'cross-over' deals that could influence financial or futures instruments.

manipulation standard, which does not require fraud, but requires evidence that the accused manipulator caused or attempted to cause artificial prices.³⁷

Notwithstanding the jurisdictional uncertainty, any target of a market manipulation investigation involving either or both the physical energy markets and related financial markets can expect a high degree of

information sharing and cooperation between the staffs of the CFTC and FERC.³⁸ The Dodd-Frank Act required FERC and the CFTC to enter into memoranda of understanding (MOUs) that address information sharing and jurisdictional issues.³⁹

30. Commodity Exchange Act, 7 U.S.C. § 1a (47); 17 C.F.R. §§ 1.3 and 32.2.

31. *Forward Contracts with Embedded Volumetric Optionality*, Proposed Interpretation, 79 Fed. Reg. 224 (Nov. 20, 2014), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-27285a.pdf>.

32. 17 C.F.R. § 32.3; see also CFTC Staff No Action Letter No. 13-08 (April 5, 2013); *CFTC Division of Market Oversight Response to Frequently Asked Questions Regarding Commodity Option*, https://forms.cftc.gov/_layouts/TradeOptions/Docs/TradeOptionsFAQ.pdf.

33. See *Brian Hunter v. FERC*, 711 F. 3d 155 (2013) (holding that the CFTC had exclusive jurisdiction over Brian Hunter, a trader at Amaranth, and alleged market manipulation involving trading natural gas futures, a financial instrument bought and sold on the New York Mercantile Exchange, to benefit, and with the intent to benefit, Amaranth's financial position in natural gas swaps, also CFTC-regulated financial instruments.).

34. Charles R. Mills, Megan E. Vetula, *CFTC Exclusive and Enforcement Jurisdiction After Dodd-Frank and Hunter v. FERC*, 33 No. 9 Futures & Derivatives L. Rep. 1 (2013).

35. *BP America Inc. et al.*, 147 FERC ¶ 61,130 (2014) (order establishing hearing).

As of the end of January 2015, the parties and Staff had filed testimony, respondent's request for rehearing on jurisdiction and other issues remained pending before the FERC with the administrative hearing scheduled for March 2015.

36. 7 U.S.C. § 9(1)(C).

37. The Commodity Exchange Act, as amended, 7 U.S.C. § 9(1)(B), expressly states that the new market manipulation prohibition added by section 753 of the Dodd-Frank Act, 7 U.S.C. § 9(1), amending prior section 6(c) of the Commodity Exchange Act, does not affect the CFTC's preexisting market manipulation authority found in 7 U.S.C. § 13(a)(2) of the Commodity Exchange Act, as amended; see *U.S. CFTC v. Wilson*, 27 F. Supp. 3d 517 (S.D.N.Y. 2014) (discussing the four-part test for market manipulation under the CFTC's pre-Dodd-Frank market manipulation standard).

38. Steven F. Reich, Charles F. Connelly and J. Porter Wiesman, *Enforcement Times Two*, Public Utility Fortnightly 14, July 2014 (Reich, *Enforcement*).

39. 15 U.S.C. § 8308.

On January 2, 2014, FERC and CFTC entered into two such MOU agreements.⁴⁰

One of the two MOUs sets forth a process for staff-level cooperation between the two agencies.⁴¹ It expressly does not address legal jurisdiction.⁴² The second MOU addresses information sharing.⁴³ It allows each agency to access information obtained by the other agency from market participants within the other agency's jurisdiction. This second memorandum also reflects an agreement by both the CFTC and FERC "to coordinate to the extent practicable oversight (including market surveillance, investigation, and enforcement activities of mutual interest.)"⁴⁴

Additional agency cooperation and other events portend increased enforcement oversight by FERC and the CFTC. FERC now regularly screens market data for anomalous behavior using increased data analytics and surveillance tools that became systematized in early 2012.⁴⁵ FERC also has access to, and uses, data from the CFTC's "large trader" reporting system to analyze market participant behavior.⁴⁶

The Investigation: When All Else Fails

Agency enforcement priorities will continue to evolve, and no compliance system, even an effective one, can prevent all potential manipulation. Sometimes, however, for whatever reason, corporate compliance programs and employee training fail, and misconduct may occur. When it does, businesses and individuals can face an investigation. In the preferred scenario, the company's own compliance audit or employee hotline reporting systems would lead to the detection of questionable conduct and the company would be in a position to consider remedial measures, compliance policy changes, re-training and/or discipline, and, where appropriate, voluntary self-disclosure. Failing that, the company may confront a government investigation.

The FERC and CFTC investigative processes are quite similar. FERC investigations proceed along either a "preliminary" or "formal" track.⁴⁷ A formal investigation begins when the

Commission itself issues an Order of Investigation, which activates the enforcement staff's authority to use subpoenas.⁴⁸ Enforcement staff may initiate preliminary investigations by their own discretion and "informally" request data and documents in that context.⁴⁹ The CFTC staff, similarly, can only issue subpoenas when authorized by the Commission.⁵⁰

If FERC enforcement staff concludes that a violation has occurred, the staff presents the respondent with its findings, "including both the relevant facts and legal theories," and offers an opportunity to respond, generally within 30 days.⁵¹ Similarly, CFTC generally informs respondents of "the nature of the allegations pertaining to them," and offers the opportunity to submit a response within 14 days.⁵²

If the staff of either agency seeks civil sanctions and settlement attempts fail, the Commissions, assuming they agree with

Once you face a formal investigation, consider conducting an internal review. It may win more favorable treatment – especially if followed by cooperation and self-disclosure.

the staff's findings, may bring enforcement actions either in federal court or in an agency proceeding before an ALJ.⁵³ In one key exception where the investigation involves alleged violations of the Federal Power Act, the respondent may choose between (a) a FERC administrative hearing, followed by Commission review of the ALJ's findings, appealable to a

federal circuit court, or (b) immediate assessment of a civil penalty, followed by *de novo* review of both the law and the facts in a federal district court.⁵⁴ Finally, either agency may refer potential criminal violations to the Department of Justice for prosecution.⁵⁵

Notwithstanding differences between CFTC and FERC rules, businesses and individuals under investigation should swiftly consider taking the following actions to minimize potential penalties and the risk of litigation:

- Determine whether to conduct an internal investigation;
- Take immediate steps to ensure preservation of appropriate documents; and
- Cooperate with the agency staff and take and document action to prevent recurrences of the alleged misconduct.

40. Memorandum of Understanding Between the Federal Energy Regulatory Commission and Commodity Futures Trading Commission, (Jan. 2, 2014), <https://www.ferc.gov/legal/mou/mou-ferc-cftc-jurisdictional.pdf> (MOU on Overlapping Jurisdiction); Memorandum of Understanding Between the Federal Energy Regulatory Commission and Commodity Futures Trading Commission Regarding Information Sharing and Treatment of Proprietary Trading and Other Information, (Jan. 2, 2014), <https://www.ferc.gov/legal/mou/mou-ferc-cftc-info-sharing.pdf> (MOU on Information Sharing).

41. MOU on Overlapping Jurisdiction.

42. *Id.* at 3.

43. MOU on Information Sharing.

44. *Id.* at 3.

45. 2014 Bay Senate Testimony.

46. Enforcement Staff Report 2014 at 3; Reich, *Enforcement* at 14.

47. See generally Allison Murphy, Todd Hettenbach, Thomas Olson, *The FERC Enforcement Process*, 35 Energy Law Journal 283, 289-291 (2014).

48. 18 C.F.R. § 1b.1(a); 18 C.F.R. § 1b.13.

49. 18 C.F.R. §§ 1b.6.

50. 17 C.F.R. § 11.2 (a).

51. 18 C.F.R. § 1b.19.

52. 17 C.F.R. Part 11, Appendix A.

53. 15 U.S.C. § 717s; 15 U.S.C. § 717e-1; 7 U.S.C. 9; 7 U.S.C. 13a-1.

54. 16 U.S.C. § 823b(d)(2)-(3).

55. 16 U.S.C. § 825m (a); 15 U.S.C. §§ 717s(a), 3414(b)(5).

A business facing a FERC or CFTC investigation should consider whether to conduct an internal investigation. If one is to be conducted, management will need to determine the focus of the internal investigation and who should conduct the investigation.

In performing the cost-benefit determination of whether to proceed with an internal investigation, companies should weigh the fact that an internal investigation may allow the company to mitigate penalty exposure. Both FERC and the CFTC have stated that performing an effective internal investigation, particularly one followed by appropriate remedial measures and self-reporting, can lead to more favorable treatment by the agencies.⁵⁶

CFTC has long credited companies' cooperation when determining the appropriate penalty for a violation. A 2007 CFTC Enforcement Advisory makes clear that a prompt internal investigation is a key element of such cooperation. In that advisory, the CFTC Enforcement Division specified three factors it considers in evaluating cooperation, the first of which is the company's "good faith in uncovering and investigating misconduct."⁵⁷

The same CFTC guidance also states that, "if a company has seen or received indications of wrongdoing, *but waited for a government inquiry to take action or uncover ongoing misconduct*, such inaction may suggest to the Division [of Enforcement] that the company has little interest in recognizing and taking responsibility for its misconduct," undercutting whatever cooperation credit might otherwise be available.⁵⁸

For its part, FERC has indicated that it considers the company's self-investigation measures in evaluating not only the company's cooperation and self-disclosure efforts, but also the "seriousness" of the underlying offense itself – an important factor in determining an appropriate penalty for any violation.⁵⁹

The Internal Investigation. In deciding who should conduct the internal investigation, management should consider tasking counsel to oversee the investigation, as opposed to internal audit personnel, so that investigative interviews and work product in the first instance are protected by the attorney-client privilege.

Management should also consider whether to retain an outside law firm or rely on in-house counsel. Outside counsel may be better positioned to maintain the privilege; if in-house counsel is used, that counsel's responsibilities should not include related

business counseling to minimize challenges to the attorney-client privilege applicable to that counsel's investigative activities.

Significantly, the FERC and CFTC each look to the *independence* of the internal investigator in evaluating a company's cooperation for purposes of assessing the appropriate penalty – CFTC's informal guidance regarding cooperation, and FERC's more systematized guidance, both ask whether the company engaged an "independent entity" to look into the conduct.⁶⁰

Apart from the potential advantages a prompt internal investigation may offer with respect to the Commissions, it can help the company address internal policy and process gaps, develop appropriate discipline, and, crucially, evaluate its civil and criminal exposure and potential defenses in dealing with the government. This evaluation of exposures and possible adjustments to training and compliance systems should be an iterative process and revisited often once the potential for a government investigation becomes known. Note that, despite different penalty guidelines, FERC and CFTC both place special emphasis on such factors as the actors' willfulness or intent and any monetary gain or loss, and, of course, an internal investigation should address these factors as well.⁶¹

Preserving Documents. If confronted with a credible suggestion of market manipulation, the business or individual under investigation should take immediate steps to preserve documents and other material relevant to the subject matter of the investigation. Although sometimes not an intuitive reaction for company executives, failure to preserve relevant material when one reasonably anticipates potential litigation – often well before the government makes information requests of the company, serves subpoenas or files any legal papers – can violate civil rules, potentially resulting in sanctions ranging from monetary penalties to preclusion of key legal arguments related to the lost evidence and default judgment on the underlying case.⁶²

Under some circumstances, failure to preserve evidence related to potential market manipulation could constitute the crime of obstruction. In the context of a potential FERC or CFTC investigation – even when neither agency has yet begun or even contemplated such an investigation – the federal criminal prohibition on the knowing destruction or alteration of documents "in

56. See *Enforcement of Statutes, Orders, Rules, and Regulations*, 132 FERC ¶ 61,216 at PP 127-129 (2010) (*Revised Policy Statement on Penalty Guidelines*);

CFTC, Enforcement Advisory: Cooperation Factors in Enforcement Division Sanction Recommendations, <http://www.cftc.gov/ucm/groups/public/cpdisciplinaryhistory/documents/file/enfcooperation-advisory.pdf> (March 1, 2007) (CFTC Cooperation Factors).

57. CFTC Cooperation Factors at 2.

58. *Id.* at 4 (emphasis added).

59. *Enforcement of Statutes, Regulations and Orders*, 123 FERC ¶ 61,156 at P 66 (2008) (*Revised Policy Statement on Enforcement*).

60. CFTC Cooperation Factors at 2; *Revised Policy Statement on Enforcement*, 123 FERC ¶ 61,156 at P 66.

61. See Natural Gas Act, 15 U.S.C. §§ 717t-717t-1; Federal Power Act §§ 825o-825o-1; Commodity Exchange Act, 7 U.S.C. § 9(10)(c)(ii); *Revised Policy Statement on Penalty Guidelines*, 132 FERC ¶ 61,216 at P 16; *In re R&W Technical Services, Ltd.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) P27,582 at 47,748 (CFTC Mar. 16, 1999) (CFTC looks to "respondent's state of mind" in determining penalty).

62. See, e.g., *Pension Committee of the University of Montreal Pension Plan, et al. v. Banc of America Securities, LLC, et al.*, 685 F. Supp. 2d 456 (S.D.N.Y. Jan. 15, 2010 *as amended* May 28, 2010).

contemplation of” the “proper administration of any matter” before any federal agency makes knowingly failing to preserve documents or data that pertain to an anticipated FERC or CFTC investigation a potential crime.⁶³

Pursuant to FERC’s “penalty guidelines,” a company that obstructs FERC’s investigation could be subject to a penalty increase of hundreds of thousands or even millions of dollars.⁶⁴ This increase can be imposed for “fail[ing] to take reasonable steps to prevent” obstruction, when done with knowledge of a violation – apparently allowing for the increase simply for not implementing a sufficient document preservation scheme in the face of market manipulation allegations.⁶⁵

The choice of document preservation system will vary depending on the circumstances and the organization. However, certain basic considerations invariably will arise. The person overseeing the document preservation should begin by identifying the key people in the fact pattern, as well as the relevant time period, to the extent possible. At a minimum, a “document hold notice,” a written communication from counsel with the instruction that relevant material must be preserved, should be circulated to those key company personnel and, potentially, contractors; depending on the circumstances, it may be necessary to circulate the notice more widely.

Consideration should be given to communicating the document hold instructions to new employees brought on after the initial hold notice, who might create or have custody of relevant materials; similarly, consideration should be given to ensuring preservation of relevant documents and data of *departing* employees. Critically, where appropriate, IT staff should be consulted regarding interrupting any automated data destruction routines, such as automatic email deletion or backup tape overwriting routines, to ensure that relevant material is not lost.

Working With Agency Staff. FERC and the CFTC will consider cooperation with agency staff in determining penalties.⁶⁶ This cooperation can take the form of (a) self-disclosure of potential violative conduct, and (b) assistance to the agencies in their own investigation and enforcement efforts.

In one significant case during 2014, the Commission approved a settlement with Direct Energy Services, LLC for market

manipulation imposing a \$20,000 civil penalty and a \$31,935 disgorgement.⁶⁷ Staff specifically attributed the “relatively small civil penalty and disgorgement payments due to its [Direct Energy’s] self-reporting, strong compliance program, quick action, and full cooperation with Enforcement’s investigation.”⁶⁸

Beyond penalty considerations, cooperation with staff can build good will that may be needed to negotiate discovery disputes, clarify technical factors and negotiate other aspects of a settlement.

Regarding criminal violations, obstruction-type violations can extend beyond failures to preserve data. If made “knowingly and willfully,” any materially false statement in connection with a federal investigation is a crime.⁶⁹ This is so whether or not the statement is made under oath. Regarding civil liability, even

Companies should weigh the fact that an internal investigation may allow the company to mitigate penalty exposure.

absent any market manipulation, both FERC and the CFTC have authority to levy fines for materially false or misleading statements or omissions in a communications to the respective agency under certain circumstances, even when the speaker did not specifically intend to mislead.⁷⁰

In addition to the standalone violations for misleading the agencies, misleading statements or lack of cooperation with FERC or the CFTC staffs are considered an aggravating factor that can lead to even higher penalties for market manipulation violations.⁷¹

For these and other reasons, utmost care and accuracy is necessary when interacting with FERC or CFTC staff in connection with an investigation. Counsel should be consulted whenever possible about communications with the agencies, and witnesses should be carefully prepared to speak truthfully and precisely, to candidly acknowledge failures of memory, and to be clear when they are and are not speaking from personal knowledge. ■

63. 18 U.S.C. § 1519. This criminal statute, a violation of which constitutes a felony that carries a maximum 20-year jail sentence, was promulgated as part of the Sarbanes-Oxley Act on the heels of the Enron and Arthur Andersen scandals.

64. *Revised Policy Statement on Penalty Guidelines*, 132 FERC ¶ 61,216 at 62,157, FERC Penalty Guidelines at § 1C2.3(e); *see also Enforcement of Statutes, Regulations and Orders*, 123 FERC ¶ 61,156 at P 68 (2008).

65. *Revised Policy Statement on Penalty Guidelines*, 132 FERC ¶ 61,216 at 62,153, FERC Penalty Guidelines at § 1B2.1.

66. *Revised Policy Statement on Penalty Guidelines*, 132 FERC ¶ 61,216 at P 142 and 62,157, FERC Penalty Guidelines § 1C2.3.(g); CFTC Cooperation Factors at 2-3.

67. Enforcement Staff Report 2014 at 4.

68. *Id.* at 4.

69. 18 U.S.C. § 1001(a) (felony carrying a 5-year maximum jail sentence); *see also* 18 U.S.C. § 1516 (obstruction of federal audit, a felony carrying a 5-year maximum jail sentence).

70. 7 U.S.C. §§ 9(2), (10)(C)(i) (liability for false or misleading statement or omission to CFTC when speaker “reasonably should have known” it to be false or misleading with penalty of up to \$140,000 per violation or triple the monetary gain); 18 C.F.R. § 35.41(b) (liability for false or misleading statement or omission to FERC); *Kourouma*, 135 FERC ¶ 61,245 (2011) (noting that the penalty for violations of 18 C.F.R. § 35.41(b) is up to \$1 million per violation per day); *Kourouma v. FERC*, 723 F.3d 274, 278 (D.C. Cir. 2013) (“[I]ntent to deceive is not an element of [18 C.F.R. § 35.41.]”).

71. *Revised Policy Statement on Penalty Guidelines*, 132 FERC ¶ 61,216 at 62,157, FERC Penalty Guidelines at § 1C2.3 (e); CFTC Cooperation Factors at 4.