Energy Markets: Overlap and distinctions between CFTC and FERC regulation and enforcement

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What Does FERC Do?

FERC regulates many aspects of wholesale natural gas, electricity, oil and hydropower industries

It conceives its mission as:

- **Regulation of Transmission and Ratemaking** – "just and reasonable" rates for:
  - The transmission and sale of natural gas for resale in interstate commerce
  - The transmission of oil by pipelines in interstate commerce
  - The transmission and wholesale sales of electricity in interstate commerce
- **Licensing**: Licenses and inspects private, municipal, and state hydroelectric projects
- **Gas infrastructure permitting:** Approves the siting of and abandonment of interstate natural gas facilities, including pipelines, storage and liquified natural gas terminals
- **Reliability**: Ensures the reliability of high voltage interstate transmission system

What Does FERC Do? (cont'd.)

- **Market oversight**: Monitors and investigates energy markets
- **Enforcement**: Imposes civil penalties and other remedies against energy organizations and individuals who violate FERC rules in the energy markets
- **Environmental:** Oversees environmental matters related to natural gas and hydroelectricity projects and major electricity policy initiatives
- **Accounting and Reporting**: Administers accounting and financial reporting regulations of regulated companies
- FERC statutes and regulations
  - Federal Power Act (FPA)
  - Natural Gas Act (NGA)
  - Public Utilities Regulatory Policy Act (PURPA)
  - Interstate Commerce Act (ICA)

Who is Regulated by FERC?

- Generators of electric power in interstate commerce (all forms)
- Electric power transmission companies
- Organized power markets (Independent System Operators (ISOs) and Regional Transmission Organizations (RTOs))
- Interstate oil, natural gas pipelines
- Natural gas storage operators
- Liquified natural gas terminals

What is FERC's Scheme of Regulation?

- **Tariffs:** FERC-regulated markets operate pursuant to elaborate prescriptive sets of rules, called "tariffs"
  - Examples
    - Standards and instructions for bidding physical power into organized power market
    - Standards for scheduling the transmission of power
    - Standards for rates charged for transporting natural gas on an interstate pipeline
- **Market Behavior Rules**: Rules that set forth affirmative obligations when buying and selling wholesale electric power
- **Anti-Manipulation/Antifraud Rules:** Proscriptions against deceit in and in connection with the purchase or sale of interstate power and natural gas
- **Transaction and Financial Reporting Rules**
- **Pipeline Certificate Process**: Jurisdiction over siting interstate oil and gas pipelines

CFTC Markets and Market Participants

- Futures, Swaps, and Options
- Anti-Fraud, Manipulation in Spot Markets

Futures Market Regulation

- Exchange rules
- Recordkeeping (1.35)
- Large trader reporting (Part 16 Rules)
- Position limits (Part 150 Rules)

Swaps Market Regulation

- Recordkeeping (1.35)
- SDR reporting (Parts 43, 45)
- Legal entity identifier (45.6)
- End-user exception from clearing (Rule 50.50)

Registration Categories

- **Commodity Pool Operator (CFTC Rule 1.3, Part 4):** an individual or organization that operates a commodity pool and solicits funds for that commodity pool. A commodity pool is an enterprise in which funds contributed by a number of persons are combined for the purpose of trading futures contracts or options on futures, retail off-exchange forex contracts, or swaps, or to invest in another commodity pool.
- **Commodity Trading Advisor (CFTC Rule 1.3, Part 4)**: an individual or organization that, for compensation or profit, advises others, directly or indirectly, as to the value of or the advisability of buying or selling futures contracts, commodity options, retail off-exchange forex contracts or swaps.
- **Swap Dealer Registration (CFTC Rule 1.3, Part 23)**: an organization that holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties as an ordinary course of business for its own account, or engages in any activity causing the organization to be commonly known in the trade as a dealer or market maker in swaps.
    - Registration required for swap dealing activity exceeding $8 billion over preceding 12 months
    - Activities based test
    - Previously proposed, but did not adopt, amendment to except swaps entered into to hedge financial or physical positions

Scope of FERC's Enforcement Power

Broad enforcement power: Violation of any FERC regulation or FERC-approved tariff is a potential compliance issue, and subject to sanction

- "It shall be unlawful for any person to violate any provision of subchapter II or any rule or order issued under any such provision." FPA Section 316A
  - *see also* NGA sections 14 and 20

- **Anti-manipulation and antifraud rules**: As construed by FERC, any entity or natural person who attempts to or in fact engages in manipulation or fraud in or in connection with transactions in electric power and natural gas is subject to its enforcement powers
- **Market behavior rules**: FERC-regulated entities
- **NERC Reliability Standards**: Transmission companies

Key Issues in FERC Enforcement

- Compliance with tariffs
- Market manipulation
- False and misleading statements and omissions
- Violation of the Market Behavior Rules
- Financial integrity/creditworthiness in energy transactions
- Reliability violations with respect to electricity transmission
- Failure to maintain required records

FERC's Anti-Manipulation/Antifraud Rules

- **FERC Rules 1c.1 and 1c.2 are patterned on SEC Rule 10b-5**
  - Prohibited Conduct
    - Use of any manipulative device, scheme or artifice
    - Untrue statements of material fact
    - Material omissions
    - Fraudulent or deceptive act or practice
  - With requisite intent (or reckless conduct)
  - "In connection with"
    - FERC-regulated purchase/sale of electric energy or natural gas
    - FERC-regulated transmission of electric energy or transportation of natural gas
- **FERC broadly construes the Rule to:**
  - Reach attempted and well as perfected manipulation and fraud
  - Not require a showing of harm or an artificial price
  - Reach "[a]ny action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market"

Safe Harbors/Affirmative Defenses

- Behavior is "explicitly contemplated in Commission-approved rules and regulations"
  - But beware of the "there was no prohibition" defense
- Actions were taken "at the direction of an ISO or RTO"
- NOT Safe Harbors:
  - Trying to "make money"
  - Trying to "avoid losses"
  - Hedging
  - Arbitrage

Consequences of Non-Compliance

- FERC civil penalties of up to ~ $1.3M per day/per violation
- Disgorgement of unjustly earned profits (plus interest)
- Loss of market based rate authority
- Mandated compliance plans
- Personal liability for individuals
- Criminal prosecution
- Negative attention/reputational harm

Scope of CFTC Enforcement

- The laws apply to virtually every entity and natural person whose actions affect derivative markets, including those involving energy
- Every person potentially is subject to prosecution if he or she
  - Engages in unlawful behavior
  - Assists or knowingly or recklessly participates in another’s unlawful behavior or scheme, or
  - Controls or supervises another person who engages in unlawful behavior
- Entities can be derivatively liable for the unlawful conduct of their directors, officers, employees and agents

Activity Subject to CFTC Enforcement Jurisdiction

Energy transaction can be subject to CFTC anti-manipulation and antifraud statutes and rules

- Cash, spot and forward transactions in physical commodities
- Options on physical commodities
- Over-the-counter financial derivatives (*e.g.*, swaps, financial options)
- Exchange-traded commodity futures and options

CFTC Antifraud Rule 180.1

- Patterned on Securities and Exchange Commission Rule 10b-5
- CFTC Rule 180.1 generally prohibits any person from knowingly or recklessly defrauding or deceiving anyone or manipulating a commodity's or derivative's price in connection with a transactions in a physical commodity, futures or swap
- **Mental intent:** "Recklessness" satisfies the intent element
  - The CFTC has stated that recklessness is an act or omission that "departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing"
- **Proof of price impact not required:** CFTC takes the position that a market price impact is not a necessary element of a violation of Rule 180.1

CFTC Antifraud Rule 180.1 (cont'd.)

- **Broad scope:** CFTC has stated that it will apply Rule 180.1 to "the fullest extent allowed by law" when determining whether conduct is subject to the CFTC's jurisdiction
- **Supervision:** The CFTC treats supervisory failures as one of the facts and circumstances it considers in determining whether a violation of the Rule exists
- **Trading on proprietary information:** Rule 180.1 does not prohibit market participants from trading on the basis of material, non-public information that they <u>lawfully</u> possess

What Constitutes “Manipulation”?

The government’s expansive view of wrongful behavior:

- Trading for the specific purpose of raising, lowering or stabilizing a market price is unlawful even if the transactions are otherwise lawfully executed in the market.
- Any conduct that intentionally or recklessly corrupts or impairs the integrity of price-setting processes.
    - CFTC: When a market is constrained or congested, entering into a transaction that “exacerbates” the constraint or congestion could constitute manipulation.

Examples: Manipulation and Fraud Charges

- **False market rumors:** Knowingly or recklessly spreading false rumors about market information that could affect market pricing.
  - Spreading someone else's false rumor while knowing or having reason to suspect it is false can be as actionable as starting a false rumor.
- **False reporting:** Knowingly or recklessly reporting false transactional information (price and/or volume information) to a price index publisher (*e.g.*, Platts)
- **"Uneconomic" trading**
  - Intentionally buying at a higher price (or selling at a lower price) when a better price is available, for the purpose of causing the market price to be higher (or lower) than it would have been otherwise.
  - Purposely trading at an economic loss in one position or product (*e.g.*, forward contracts in physical commodities) in order to favorably affect the value of a position in another position or product (*e.g.*, a financial swap position).

Examples: Manipulation and Fraud Charges (cont'd.)

- **Using market power for the purpose of causing price impacts**
  - Dumping substantial quantities of a commodity at a pricing hub/ delivery point for the purpose of causing lower prices
  - Withdrawing from the market substantial quantities of a commodity at a pricing hub for the purpose of causing a supply shortage and higher prices
  - Cornering: Buying almost all deliverable supply and establishing a dominant position in the commodity's long futures contract in order to exercise power to dictate prices to short futures contract holders
  - Unlawful squeeze: Causing or exacerbating a supply shortage in order to squeeze favorable prices from short derivatives contract holders

Examples: Manipulation and Fraud Charges (cont'd.)

- **Marking the close or price window**
  - Entering large orders during the close of a futures contract or the pricing window of an over-the-counter product for the purpose of moving the settlement price higher or lower or stabilizing it.
- **Disorderly trading in the close**
  - Executing trades or submitting bids or offers that demonstrate intentional or reckless disregard for the orderly execution of transactions during the closing period.
  - **CFTC view:** Disorderly trading could be inferred when trading in a manner that intentionally or recklessly causes the relationships between the price of a derivative and the underlying commodity to diverge or causes spreads between near and remote months to unreasonably diverge.
- **False signaling and spoofing**
  - Using orders or trades for the purpose of causing false market signals of supply or demand in order to move the price for a trader's benefit.

Examples: Manipulation and Fraud Charges (cont'd.)

- **Misappropriation:**
  - **Trading on the basis of unlawfully obtained material, nonpublic information**
    - "Unlawfully" obtained information depending upon the facts potentially might be construed to include information received from another firm in breach of a duty of confidentially that the other firm's employee owes to his or her employer
- **Front running:** Trading ahead of the execution of an order of a market participant to whom the trader owes a duty of loyalty
  - Example:
    - Trading for one's personal account ahead of the execution of an order for global partners or a customer

Prohibited Noncompetitive Transactions

- **Wash sales**
  - Buying and selling at the same or nearly the same price
  - Prearranged/collusive transactions
  - No financial risk
    - Wash sales are considered to create a false appearance of market liquidity and of market interest at a particular price level
- **Collusive trades on trading platforms at predetermined terms**

Liability for False Statements to the Government, or Exchanges

- Criminal and civil liability attaches to intentionally or recklessly making false or misleading statement of a material fact to the CFTC, commodity futures exchanges, FERC, or other regulatory and self-regulatory authorities
  - This potentially covers *any* statement of a material fact
- Statements made in regulatory reports
- Oral responses to surveillance staff
- Statements in investigative testimony
- Statements in registration applications)

Control Person Liability Under the CEA

- Under the CEA, any person who "controls" the activities of another can be held liable for the controlled person's violation if he or she:
  - Did not act in good faith, or
  - Knowingly induced, directly or indirectly, the act or acts constituting the violation
- Indicia of control include: exercising day-to-day authority over a firm's operations, performing important managerial and supervisory functions, possessing final authority on hiring and firing decisions, controlling finances, and setting compensation for employees
- "Knowing inducement": Control person had actual or *constructive* knowledge of the core activities that make up the violation and allowed them to occur or continue

Congressional Jurisdiction

	CFTC		FERC
House Authorizing	Agriculture		Energy & Commerce
Senate Authorizing	Agriculture		Energy & Natural Resources
House Oversight	Oversight & Reform		Oversight & Reform
House Appropriations	Agriculture Subcommittee		Energy Subcommittee
Senate Appropriations	Financial Services Subcommittee		Energy Subcommittee

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