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Attack of the Clone: FERC's Anti-Manipulation Rule Uses SEC Tools

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INTRODUCTION

The Federal Energy Regulatory Commission (FERC or Commission), which in the past enforced energy laws against natural gas and energy wholesalers and transporters, broadened its enforcement umbrella in 2007. For the first time, the Commission sent an Order to Show Cause (OSC) to a hedge fund trading in energy futures markets, Amaranth Entities (Amaranth).[1] In its OSC, the Commission directed Amaranth to show why it had not violated its new regulation[2] that prohibits the manipulation of natural gas prices. FERC's new Anti-Manipulation Rule utilizes Security and Exchange Commission (SEC) case law and regulations to guide FERC in its broadened enforcement field. FERC's action against Amaranth stems from Order No. 670, a final Rule that the agency implemented in January 2006. Distilled, Order No. 670 prohibits any entity from intentionally or recklessly manipulating natural gas and energy transactions that fall within the Commission's jurisdiction.

The Commission's position is that the Energy Policy Act of 2005 (EPAct) expanded its jurisdiction to cover transactions where there is a nexus between market manipulation and the purchase, sale, transportation or transmission of natural gas or electric energy. Amaranth has vigorously challenged FERC's jurisdiction at the agency level, in district court, and, at the time of writing, in the D.C. Circuit. If the Commission's jurisdiction is upheld, it will have the capacity to prosecute entities that were previously outside its regulatory scope.

FERC's ANTI-MANIPULATION RULE MIRRORS SEC RULE 10b-5[3]

Until 2005, the Commission predominantly regulated investor-owned public utilities and natural gas transportation.[4] It was not a bona fide enforcement agency, like the SEC. However, in light of the *2000–2001 western power crisis,*[5] and the Commission's failure to regulate market manipulation, Congress broadened FERC's enforcement powers. Sections 315 and 1283 of EPAct 2005,[6] amended the Natural Gas Act (NGA)[7] and Federal Power Act (FPA),[8] respectively, to "prohibit the use or employment of manipulative or deceptive devices or contrivances in connection with the purchase or sale of natural gas, electric energy, or transportation or transmission services subject to the jurisdiction of the Commission."[9] These anti-manipulation sections mimic the "prohibited conduct language in Section 10(b) of the Security and Exchange Act of 1934[10]," and dictate that the terms *manipulative or deceptive devices or contrivances* mirror the meaning that these terms have in the Exchange Act.[11]

FERC maintains that EPAct 2005 is not an expansion of its subject matter jurisdiction, but rather that EPAct provides it with "broad jurisdiction over the entities that engage in certain conduct affecting our subject matter jurisdiction."[12] Pursuant to EPAct Sections 315 and 1283, FERC implemented Order No. 670 to combat fraudulent activities in the natural gas and electric energy market.[13] In implementing the Rule, the

Commission said that "the Rule is not intended to regulate negligent practices or corporate mismanagement . . . [its intent is] to deter or punish fraud in the wholesale energy markets."[14] The Rule's narrow intent, however, may be stretched by the Commission's application of it to Amaranth.

Prohibition of Energy Market Manipulation

The Anti-Manipulation Rule overseeing the energy markets is Order No. 670, which provides:

> § 1.c.1 Prohibition of Natural Gas Market Manipulation
>
> (a) It shall be unlawful for any entity, directly or indirectly, in connection with the purchase or sale of natural gas or the purchase or sale of transportation 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 material fact or to omit to state a material fact necessary in order to make the statements made, in 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.
>
> (b) Nothing in this section shall be construed to create a private right of action.
>
> § 1c.2 Prohibition of Electric Energy Manipulation
>
> (a) It shall be unlawful for any entity, directly or indirectly, in connection with the purchase or sale of electric energy or the purchase or sale of transmission services subject to the jurisdiction of the Commission.[15]

The Mechanics

Order No. 670 appears straightforward, but it requires some detailed analysis for understanding its unique interaction with SEC Rule 10b-5. Basically, FERC's Rule is violated if *any entity* engages in intentional or reckless manipulation, and the conduct is "in connection with" a jurisdictional transaction.[16] The most critical issue in analyzing a potential violation is whether the alleged conduct involved a jurisdictional transaction. If it did, then one must fully consider the Rule's five elements. The elements for a violation are: (1) an entity; (2) scienter; (3) manipulation; (4) nexus; (5) a jurisdictional transaction.

First, the term *any entity* is deliberatively inclusive and applies to any person or form of organization, regardless of its legal status.[17] The term *entity* applies both to the entity engaged in the fraudulent conduct and to the entity that is manipulated.

Second, the Rule requires at least reckless conduct[18] that the Commission will determine "on a case-by-case basis, by [looking to] analogous security law precedent."[19] Similar to SEC Rule 10b-5, "there can be no violation of [Order No. 670], absent a showing of the requisite scienter."[20] For guidance in interpreting the scienter element, FERC will consider "the abundant securities law precedent" that highlights Rule 10b-5's "analogous section."[21]

Third, the term "manipulation" must be understood with reference to SEC case law and the Exchange Act of 1934.[22] Thus, to prove manipulation, FERC must show that the defendant: (1) made a material misrepresentation or material omission as to which he had duty to speak, or used a fraudulent device; (2) with scienter; (3) in connection with a jurisdictional transaction.[23] Fraud is broadly defined to "include any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market."[24] To establish manipulation, the Commission does not have to show reliance or harm.[25] Also, manipulation may arise from an artificial increase or decrease to the price of electricity or natural gas.[26]

Fourth, the nexus requirement must tie an entity's manipulation to a transaction over which the Commission has jurisdiction. This "in connection with" requirement cannot be properly discussed without also discussing the fifth element: a jurisdictional transaction. The Commission's jurisdiction is limited to certain wholesale transactions that remain within the ambit of the Natural Gas Act, the Natural Gas Policy Act,[27] and the Federal Power Act. Thus, the Commission's subject matter jurisdiction appears relatively limited; and it does not intend "to convert every common law fraud that happens to touch a jurisdictional transaction into a violation."[28] Rather, for FERC to assert its new jurisdiction, an entity must have intended or acted recklessly to affect a jurisdictional transaction.[29]

According to the Commission, "the Anti-Manipulation Rule applies whether or not the manipulator's principal or exclusive purpose is the manipulation of physical gas sales."[30] For example, FERC maintains it would have jurisdiction over:

> Any entity engaging in a non-jurisdictional transaction through a Commission-regulated Regional Transmission Organization (RTO)/Independent System Operators (ISO) market, that acts with intent or recklessness to affect the single price auction clearing price (which sets the price of both non-jurisdictional and jurisdictional transactions), would be engaging in fraudulent conduct in connection with a jurisdictional transaction and, therefore, would be in violation of [Order No. 670].[31]

This nexus requirement is another area where FERC relies heavily on SEC precedent. In *SEC v. Zanford*,[32] the issue was whether a self-dealing stockbroker who sold his client's securities without authorization violated SEC Rule 10b-5. The Supreme Court found that the SEC had jurisdiction over Zanford's conduct because it involved "a fraudulent scheme in which the securities transaction and breaches of fiduciary duty coincide . . . [t]hose breaches were therefore 'in connection with' securities sales within the meaning of 10(b)."[33] The Commission, relying on SEC precedent, maintains that it could have jurisdiction when manipulation "coincides" with a jurisdictional transaction.[34]

Fifth, a jurisdictional transaction is one that remains within the ambit of the NGA, NGPA, and FPA. In general, this means that manipulation of non-jurisdictional transactions would not violate Order No. 670. For example, the Commission lacks jurisdiction over intrastate oil pipeline transportation[35]; "first sales" of natural gas that were removed from FERC's jurisdiction by the NGPA; sales of imported gas; Hinshaw pipelines[36]; retail sales of electric energy; sales of electric energy in intrastate commerce; sales of electric energy by governmental entities; certain electric power cooperatives; and certain interstate transmissions by governmental entities.[37]

Distinctions Between Securities Law and Order No. 670

There are several important distinctions between Order No. 670 and SEC Rule 10b-5. Most important are the distinctions in the laws' mandates for disclosure. SEC Rule 10b-5, and its case law, impose an affirmative obligation to disclose nonpublic, material information obtained pursuant to a fiduciary relationship.[38] Order No. 670 imposes "no affirmative duty of disclosure" absent some tariff requirement or FERC directive.[39] That said, any *voluntary* disclosure or mandated disclosure that misstates or omits a material[40] fact *may* result in a violation of Order No. 670.

Additional distinctions between the laws include their provisions governing penalties and statutes of limitation. EPAct 2005 authorizes civil fines of $1 million per day per violation and disgorgement of profits.[41] Violations of securities laws vary from criminal prosecution of individuals to civil fines up to $5 million.[42] Order No. 670 has a statute of limitation of five years, while Sarbanes-Oxley mandates that an action commence within two years of a violation's discovery.

In addition, securities law permits private rights of action; whereas, there is no private right of action permitted under Order No. 670.

CFTC—FERC Cooperation Agreement

To understand the Rule's application there must be an exploration of FERC's complementary jurisdiction with the Commodity Futures Trading Commission (CFTC). In short, "CFTC has jurisdiction over trading on its regulated exchanges, [FERC] has jurisdiction over certain types of natural gas and electric markets, and where these markets are interconnected, both agencies have jurisdiction to prohibit market manipulation."[43] Because manipulation of energy markets could affect the price of wholesale energy and gas, Congress required that FERC enter into a Memorandum of Understanding (MOU) with the CFTC.[44] In October 2005, the two agencies entered into a MOU to establish provisions for coordinating investigations. Specifically, the MOU requires the agencies to coordinate their discovery requests; to share information; maintain confidentially unless the data is derived in the aggregate (the data does not disclose trades secrets or positions of persons involved); and to meet regularly.[45]

In the Amaranth case, the two agencies worked closely for a year to coordinate discovery and proceedings in the case.[46] The investigation began in 2006, when FERC's Division of Energy Market Oversight (DEMO) observed a sharp decline in the price of Natural Gas Futures Contracts during the close of trading on several occasions. DEMO analyzed its settlement price data and referred the matter to FERC's Enforcement Division of Investigation (Investigations). Investigations contacted the CFTC (pursuant to the provisions set forth in the MOU), to learn the identity of the traders. CFTC provided information to FERC that identified the traders with the largest positions and trading volume during the applicable periods. This information sharing brought about the investigation into Amaranth's conduct.[47]

The Beast with Two Heads—*In re* Amaranth

The alleged facts in Amaranth involve the nexus between the wholesale interstate natural gas markets, which are governed by FERC, and the New York Mercantile Exchange (NYMEX) Natural Gas Futures Market."[48] Basically, FERC and CFTC claim that Amaranth manipulated the price of wholesale natural gas downward by trading in Natural Gas Futures Contracts[49] just before trading closed, on three separate occasions in 2006. The settlement price[50] that Amaranth allegedly drove down explicitly determines the price in a substantial volume of Commission-jurisdictional transactions. Amaranth may have benefited from the low settlement price because it had "previously taken positions several times larger in various financial derivatives whose value increased as a direct result of the decrease in the settlement price of the NG Futures Contracts."[51]

Amaranth's financial derivatives were mostly *swaps* that derive their value based on the settlement price of NG Futures Contracts. A *swap* is a purely financial instrument "that operates like a NG Futures Contract except that, rather than becoming a physical delivery . . . it settles financially at the termination of the NG Futures Contracts at the NG Futures Contract final settlement price."[52] That final settlement price is determined on the third to last business day of the month.

A buyer of a swap agrees to pay a *fixed price* at the time the transaction occurs. The seller of the swap pays a *floating price* which will be the actual settlement price of the NG Futures Contract; which is unknown at the time of the transaction. This means that a buyer of a swap profits if the *floating price* is higher than the fixed priced when the settlement price is determined. The seller profits if the floating price is lower than the fixed price when the settlement price is determined. Thus, a seller of swaps who could drive down the settlement price could benefit substantially because the seller recovers the price difference between the fixed price and the floating price.[53]

On July 25, 2007, the CFTC brought an action against Amaranth alleging price manipulation with respect to Natural Gas Futures Contracts, seeking injunctive relief and civil penalties in the district court of the Southern District of New York.[54] On July 26, the very next day, FERC commenced an administrative enforcement proceeding "based essentially on the same transaction, for civil penalties and disgorgement of profits."[55] Thus, at the end of July, Amaranth faced two prosecutions by two federal agencies in two completely "different jurisdictions, based on the same alleged conduct."[56] Amaranth immediately challenged FERC's jurisdiction in an administrative hearing and sought a preliminary injunction against FERC's administrative proceeding in the district court.

Amaranth, thus far, has been unsuccessful thwarting FERC's administrative action; both at the administrative level and in federal court. On August 27, 2007, Amaranth requested an administrative rehearing to terminate FERC's Order to Show Cause (OSC), claiming that the Commission lacked subject matter jurisdiction over Amaranth's alleged manipulative trading.[57] On November 30, 2007, FERC denied the request, finding it had broad enforcement jurisdiction under EPAct 2005.[58] Further, FERC said it had jurisdiction over Amaranth's conduct because the company's actions affected jurisdictional markets.[59] What is more, FERC found that "both" it and CFTC "have an enforcement role" when their jurisdictional markets affect one another.[60]

In December 2007, Amaranth again requested the Commission to stay its OSC, so that it could obtain judicial review of its jurisdiction in the D.C. Circuit.[61] However, on December 6, 2007, FERC denied Amaranth's emergency motion to stay, and denied its motion for extension to file a response. The Commission denied Amaranth's motions, in part, because Amaranth would not suffer any irreparable harm by responding to the OSC.[62]

Amaranth has also been unsuccessful stemming FERC's advance in federal district court. On November 1, 2007, District Judge Chin, of the South District of New York, denied Amaranth's motion to enjoin FERC's administrative proceeding, finding that a preliminary injunction under Fed. R. Civ. P. 65 is only available to parties in the immediate case. Since the Commission was not a party to the case, the Court lacked jurisdiction to order an injunction pursuant to Rule 65. Although the Court found it had jurisdiction under the All Writs Act[63] to order an injunction against a non-party, it denied the injunction for two reasons: first, the Court found that the Commission's administrative action was still in its early stages; second, that the Commission's administrative proceeding was not offensive to the Court's jurisdiction. Judge Chin said, "[a]lthough it would be prudent for FERC to defer to this lawsuit [CFTC] . . . I decline to order FERC to stay its administrative action."[64]

Final Thoughts—The Importance of *FERC v. Amaranth*

FERC's enforcement jurisdiction would be seriously broadened if the Court of Appeals confirms that FERC has jurisdiction over a hedge fund's conduct. Such a court ruling, coupled with FERC's cloning of SEC precedent, would increase the pool of potential violators of Order No. 670. Entities that have limited knowledge about the Commission could be subject to its jurisdiction if the Commission decided that they artificially affected an energy market. Those entities could face, as Amaranth does, two federal agencies in two different jurisdictions in a matter derived from the same circumstances. Amaranth is illustrative of the Commission flexing its new muscle and enforcing its Anti-Manipulation Rule against energy outsiders: entities that never sold, purchased, transmitted or transported wholesale natural gas or electric energy. The case stretches the terms *in connection with a jurisdictional transaction* to embrace an entity's actions that merely coincide with a FERC jurisdictional market. By piggybacking onto SEC precedent, FERC obtains a periscope for locating manipulation, fraud, deceit, materiality, and recklessness on territories it never knew existed.

ENDNOTES

1. Amaranth Entities, 120 FERC ¶ 61,085 at ¶ 30–34; Order to Show Cause; Docket NO. IN01–26–000 (July 26, 2007). Amaranth Entities consisted of a complex array of interrelated LLCs, LLPs, and corporations to form a "hedge fund." The different funds were registered in several locations including: the Cayman Islands, Delaware, Bermuda, and Nova Scotia. [*hereinafter* Amaranth OSC].

2. 18 C.F.R. §§ 1.c1, 2 (January 19, 2006) (Anti-Manipulation Rule); 114 FERC ¶ 61,047 at ¶ 6 (Order No. 670) [*hereinafter* Rule 670].

3. 17 C.F.R. 240.10b-5 (2005) (SEC Rule 10b-5).

4. The Federal Energy Regulatory Commission "is an independent agency that regulates the interstate transmission of electricity, natural gas, and oil. FERC also reviews proposals to build liquefied natural gas (LNG) terminals and interstate natural gas pipelines as well as licensing hydropower projects." *See* www.ferc.gov/about/ferc-does.asp, for background information on the Commission.

5. Amaranth OSC, *supra* note 1, at ¶ 3. *See also*, television interview with Joseph Kelliher, FERC Chairman (2007), available at: www.eenews.net/tv/2007/31/#. Kelliher connects the amendments to EPAct 2005 §§ 315 and 1283 to the western energy market manipulation scheme of 2000–2001.

6. Energy Policy Act of 2005, Pub. L. No. 109–58, 119 Stat. 594 (2005).

7. 15 U.S.C. 717 (2000).

8. 16 U.S.C. 791(a) (2000).

9. Rule 670, *supra* note 2, at ¶ 6.

10. 15 U.S.C. 78j(b) (2000) (Exchange Act).

11. Rule 670, *supra* note 2, at ¶ 6.

12. *Id.* at ¶ 20 [brackets added].

13. *Id.* at ¶ 5.

14. *Id.* at ¶ 4 [brackets added].

15. *Note,* 18 C.F.R. § 1c.2 (a)(1–3)—(b) is virtually identical to § 1c.1 (a) (1–3)—(b).

16. Rule 670, *supra* note 2, at ¶ 16.

17. *Id.* at ¶ 19.

18. *Id.* at ¶ 53.

19. *Id.* at ¶ 45 [brackets added].

20. *Id.* [brackets added].

21. *See id.* at ¶ 53, *noting* that several Courts of Appeals are divided as to what constitutes "recklessness" satisfying the scienter requirement of SEC Rule 10b-5. For example, the Fifth Circuit applies a "severely reckless" standard or a "conscious disregard" standard. *See, Natheson v. Zonagen, Inc.*, 267 F.3d 400 (5th Cir. 2000). The Eighth Circuit requires conscious behavior sufficient to raise a strong inference of recklessness. See, *Florida State Board of Admn v. Green Tree Financial Corp.*, 270 F.3d, 645 (8th Cir. 2001). What is critical to remember, about the 670's scienter requirement is twofold: first, without recklessness there is no violation; two, FERC will apply SEC precedent to establish recklessness.

22. Supra, note 7, ¶ 6. See also, Energy Policy Act of 2005, Pub. L. No. 109–58, 119 Stat. 594 (2005).

23. Supra, note 7, ¶ 48. See, e.g. *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2nd Cir. 1999).

24. Supra, note 7, ¶ 50

25. Rule 670, *supra* note 2, at ¶ 48.

26. *See Strobl v. New York Mercantile Exchange*, 582 F. Supp. 770 (S.D.N.Y. 1984) *aff'd*, 768 F.2d 22 (2nd Cir. 1984) (condemning a conspiracy by potato farmers to artificially reduce the price of potato futures contracts).

27. Natural Gas Policy Act of 1978, 15 U.S.C § 3301.

28. Rule 670, *supra* note 2, ¶ 22.

29. *Id.* at ¶ 22.

30. Amaranth OSC, *supra* note 1, at ¶ 110.

31. Rule 670, *supra* note 2 ¶ 22 [brackets added].

32. *SEC v. Zanford,* 535 U.S. 813 (2002).

33. *Id.* at 825.

34. Amaranth OSC, *supra* note 1, at ¶ 110.

35. Rule 670, *supra* note 2, at ¶ 24.

36. A Hinshaw pipeline is either a pipeline or local distribution company that has received an exemption from regulations under the Natural Gas Act. These companies transport intrastate natural gas not subject to federal regulation. For background information on the "Hinshaw Amendment," *see* Gas Pipelines and the Hinshaw Amendment: Conflicts Loom as the "Bright Line" Fades Between State and Federal Jurisdiction, (April 1, 1997), available at available at http://www.pur.com/pubs/2344.cfm.

37. Rule 670, *supra* note 2, ¶ 20 and accompanying footnote 34.

38. *United States v. O'Hagan,* 521 U.S. 642 (1997).

39. Rule 670, *supra* note 2, ¶ 35.

40. Rule 670, *supra* note 2, ¶ 51, *noting* "A fact is material if there is a substantial likelihood that a reasonable market participant would consider it in making its decision to transact because the material fact significantly altered the total mix of information available . . . [materiality] is determined on case-by-case basis").

41. FERC Statement of Administrative Policy Regarding the Process for Assessing Civil Penalties; Docket No. AD07-4-000 (December 21, 2006).

42. See Sarbanes Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

43. Amaranth OSC, *supra* note 1, at ¶ 48

44. Memorandum of Understanding Between Federal Energy Regulatory Commission and the Commodity Futures Trading Commission, *available at:* http://ferc.gov./EventCalendar/Files/20051020121512-MOU.pdf. (2005) [*hereinafter* MOU]. *See also,* EPAct 2005, 15 U.S.C. § 717t-2(c) (1), where Congress mandated that CFTC and FERC must enter into a MOU relating to information sharing, including provisions on information requests and the proper coordination of requests to minimize duplicative information requests. *Also,* for a discussion of the scope of the MOU, *see* Statement of CFTC Chairman Walter Lukken before the Committee on Energy and Commerce (December 12, 2007) *available at:* www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-33.pdf.

45. MOU, *supra* note 44.

46. Amaranth OSC, supra note 1, at ¶ 48.

47. *Id.* at ¶ 52, 53.

48. Amaranth, *et al* Fact Sheet; Docket No. IN07-26-000.

49. A Natural Gas Futures Contract is a one month contract for the future delivery of 10,000 MMbtu of natural gas to the buyer's interconnections on the Sabine Pipe Line Co.'s Henry Hub in Louisiana. Thousands of these contracts are traded daily on NYMEX. The NG Futures Contract *settlement price* is the volume-weighted average price of trades made during the 30 minute *settlement period,* which is the last 30 minutes of trading on the *termination day* for the *prompt* month. The termination day is the third-to-last day business day of the month preceding the prompt month. *See* NYMEX Exchange Rulebook §§ 220.05, 220.10-12, available at http://www.nymex.com/rule_main.aspx?pg=33 [*hereinafter* NYMEX].

49. *Commodity Futures Trading Commission v. Amaranth Advisors, LLC.*, No. 07-cv-6682 (S.D.N.Y November 1, 2007).

50. NYMEX, *supra* note 49 (defining *settlement price*).

51. Amaranth OSC, *supra* note 1, at ¶ 5.

52. *Id.* at ¶ 18.

53. *Id.*

54. *CFTC v. Amaranth Advisors, LLC.*, No. 07-cv-6682 (S.D.N.Y November 1, 2007).

55. *CFTC v. Amaranth, supra* note 54.

56. *Id.*

57. Amaranth *et al, supra* note 48.

58. *Id.*

59. *Id.*

60. *Id.*

61. Amaranth Entities, 121 FERC ¶ 61, 238 at ¶ 1 (December 6, 2007). This Order denied Amaranth's emergency motion to stay the OSC, and its extension to file a response to the OSC. Under the NGA § 19(b), any challenge to FERC's jurisdiction must be brought in a Court of Appeals.

62. *Id.* at ¶ 5.

63. 28 U.S.C. § 1651 (All Writs Act).

64. *CFTC v. Amaranth, supra* note 54 [brackets added].