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INSIGHTS

FERC and CFTC Annual Enforcement Update

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The Federal Energy Regulatory Commission ("FERC") and the U.S. Commodity Futures Trading Commission ("CFTC") recently released their annual reports on enforcement activities for fiscal year 2016 (October 2015 through September 2016). In addition, FERC enforcement staff released two white papers regarding the bounds of FERC's prohibition on market manipulation and the features of an effective compliance program: (1) FERC Staff White Paper on Anti-Market Manipulation Enforcement Efforts Ten Years after EPAct 2005 (the "Anti-Manipulation White Paper"); and (2) FERC Staff White Paper on Effective Energy Trading Compliance Practices (the "Compliance White Paper"). Although these reports and white papers merely reflect the activities and views of enforcement staff of each of these agencies rather than the formal views of the actual commissions, these materials provide useful insight into agency staff's expectations regarding the behavior of those participating in markets subject to each agency's jurisdiction.

I. FERC

A. FERC 2016 Report on Enforcement

As in previous years, FERC's ***annual report*** highlights the agency's continued focus on preventing fraud, market manipulation, anticompetitive conduct, and conduct undermining the transparent and efficient functioning of FERC-jurisdictional markets. In 2016, FERC approved six settlement agreements between FERC's Office of Enforcement and 11 entities. All but one of these cases involved allegations that the respondents had violated the prohibition on market manipulation.[1] Collectively, these settlements resulted in the assessment of more than $12.25 million in civil penalties and disgorgement of approximately $5.7 million. FERC enforcement staff also has six separate civil actions pending in federal district court and a case pending in a U.S. Court of Appeals, each of which involve a civil penalty assessment by FERC for alleged violations of the prohibition on market manipulation.[2]

In fiscal year 2016, the Office of Enforcement's Division of Investigations opened 17 new investigations. Notably, approximately half of the new investigations opened in 2016 arose from referrals from other program offices within FERC (*e.g.*, advisory staff responsible for reviewing utility filings). This represents a departure from previous years, when the vast majority of investigations have been commenced as a result of referrals from the Office of Enforcement's Division of Analytics and RTO/ISO market monitors, and suggests that FERC advisory staff is playing an active role in identifying potential non-compliance for enforcement staff.

The Division of Investigations also brought 11 pending actions to a close with no action or through settlement. This represents a decline from 2015 and 2014 when the Division of Investigations closed 22 actions and 15 actions, respectively. While there are numerous factors that have the potential to affect the pace at which investigations proceed through the agency, this may reflect that a greater percentage of the Office of Enforcement's resources are being devoted to outstanding litigation.

B. Anti-Manipulation White Paper

The ***Anti-Manipulation White Paper*** provides an overview of FERC's enforcement efforts since Congress granted it enhanced enforcement and penalty authority as part of the Energy Policy Act of 2005. As a general matter, the white paper provides an overview of significant FERC enforcement matters and highlights conduct that FERC previously has found to be prohibited by the anti-manipulation rule, including cross-market manipulation, gaming, and misleading or deceptive conduct. The white paper also identifies several factors that FERC staff considers to be indicia of a manipulative scheme including:

· An illicit purpose: The Anti-Manipulation White Paper emphasizes that the purpose behind an entity's actions is a critical factor in determining whether conduct is fraudulent and that the "difference between legitimate open-market transactions and illegal open-market transactions may be nothing more than a trader's manipulative purpose for executing such transaction."

· Trading inconsistent with market design: The Anti-Manipulation White Paper highlights that the market manipulation rule prohibits trading a product in a manner that is inconsistent with the market design or the purpose of a product (*e.g.*, placing virtual trades for the purpose of attracting uplift or make-whole payments rather than arbitraging market spreads).

· Uneconomic trading: The Anti-Manipulation White Paper emphasizes that regularly placing uneconomic trades is a red flag for FERC enforcement staff and raises cross-market/cross-product manipulation concerns.

· Trading inconsistent with market fundamentals: In the white paper, FERC staff states that the Commission expects that entities participating in FERC-jurisdictional markets will place trades to respond to price signals driven by supply and demand.

o The white paper notes that "participants in the physical markets should be aiming to maximize their returns on the primary energy product . . . not on secondary considerations, such as make-whole payments."

o The white paper states that "participants speculating in the financial markets should express a market view based on their knowledge of market forces and conditions" and that "arbitrage should be aimed at anticipated prices of underlying products based on trading acumen and market fundamentals, not at market rules that can be exploited to profit with little to no risk."

It is important to note that much of the guidance provided in the Anti-Manipulation White Paper reflects current positions being taken by FERC in pending district court actions regarding the scope of FERC's market manipulation authority. Although the courts have endorsed FERC's views on certain issues – for instance, multiple courts have found that natural persons can be assessed civil penalties under FERC's market manipulation authority – a number of significant issues remain unresolved. For example, the white paper takes the position that market participants may not take into account out-of-market payments or other potential “collateral” sources of revenue when deciding whether to execute a trade and that trading with a purpose different from the purpose implied by the market design is prohibited by the anti-manipulation rule. Yet, it does not acknowledge that these issues currently are being litigated in district court in connection with FERC’s enforcement actions against Powhatan, City Power Marketing, and Coaltrain Energy—each of which is accused of violating the anti-manipulation rule by placing virtual transactions in the PJM market for the purpose of increasing their eligibility for certain out-of-market payments.***[3]*** Thus, while the Anti-Manipulation White Paper provides a useful overview of FERC’s precedent to-date and the agency’s views regarding the boundaries of its authority, there is not much in the way of new guidance for market participants, and it is likely that further guidance regarding these and certain other unresolved issues will come from the courts.

C. Compliance White Paper

Like the Anti-Manipulation White Paper, the ***Compliance White Paper*** provides FERC staff’s views and should inform compliance decisions by companies subject to FERC jurisdiction. Importantly, FERC staff re-emphasized that “there is no one-size-fits-all approach to compliance,” providing in the Compliance White Paper examples of compliance practices that FERC staff believes can be effective. Since the effectiveness of an organization’s compliance program is a critical factor that FERC considers when determining the appropriate remedy for allegedly manipulative conduct, those participating in FERC-jurisdictional markets may benefit from reassessing their compliance programs in light of the guidance provided in FERC’s white paper.

The Compliance White Paper emphasizes that an effective compliance program begins with an organization’s hiring, staffing, training, and technological practices. Among other things, the Compliance White Paper identifies the following components relevant to designing an effective trading program:

· hiring compliance personnel with a variety of professional and educational experiences (*e.g.*, legal, operations, risk management, and trading) to ensure that an organization’s compliance function understands both applicable legal requirements and the nature of an organization’s day-to-day trading activities;

· integrating compliance staff into the organization’s business units, including, for example, locating compliance staff on an organization’s trading floor and rotating business unit employees into compliance;

· providing compliance personnel with adequate authority to identify, report, and remedy compliance issues without interference by an organization’s business unit;

· performing background investigations on traders – both when hired and on an ongoing basis – and asking about each trader’s commitment to compliance when calling employment references;

· incentivizing compliance through compensation, including limiting eligibility for bonuses for traders who do not adhere to applicable practices and rules and providing additional bonuses for traders who show a strong commitment to compliance;

· avoiding reliance on a single, annual comprehensive training for traders and instead conducting regular trainings that are tailored to an organization's specific trading activities and that keep traders up-to-date on developments related to FERC rules and precedent;

· devoting sufficient resources to providing an organization's compliance function with access to IT resources to allow the company to monitor compliance effectively. The Compliance White Paper repeatedly emphasized the potential value of IT resources.

In addition to tailoring its staffing and training to achieve a culture of compliance, the Compliance White Paper states that an organization should establish appropriate trading rules, engage in ongoing monitoring of trading activities, and strictly enforce penalties for non-compliance. According to FERC staff, this can include:

· maintaining an up-to-date list of prohibited trading strategies and trading rules based on FERC guidance and an organization's experience such as: restrictions that prevent traders from using price-setting products to benefit related financial positions; limitations on uneconomic trading; limitations on the size of a trader's open financial positions; and preventing traders from exceeding a prescribed share of the market in a particular product;

· documenting trading strategies and requiring traders to obtain approval from compliance and/or managers before trading new products or trading at new locations;

· developing and implementing a plan for ongoing and regular monitoring of an organization's trading activities, including, for example:

o statistical reviews of position concentrations;

o reviewing activities at locations where traders engage in both physical and financial trading;

o tracking and reviewing profits and losses for each product and location;

o analyzing natural gas pipeline nominations and flows during periods of pipeline constraints;

o monitoring for changes in the amount of make-whole or out-of-market payments an organization receives;

o ensuring that cost-based offers to an RTO/ISO reflect applicable market rules;

o recording and retaining all trader communications for at least five years and reviewing employee communications on a regular basis; and

o establishing a mechanism for employees to report possible compliance concerns without fear of retribution or retaliation.

· Establishing and imposing real consequences for noncompliance; and

· Performing regular performance audits of the organization's compliance program.

While the Compliance White Paper provides useful insight into FERC staff's expectations regarding compliance programs, it is important to remember that one size does not fit all and

FERC staff's examples are not requirements. Implementation of the some of the recommendations may prove difficult in practice, and the value of some of the practices will vary based on the mix of compliance measures adopted by a company. For that reason, companies should consider the risks, benefits, and costs of each identified practice and be mindful of potential pitfalls as they consider whether and how to incorporate new practices into their compliance programs.

II. CFTC

Like FERC's report, the CFTC's fiscal year 2016 ***annual update*** highlights the agency's continued focus on market manipulation and prohibited trading activities. During 2016, the CFTC filed 68 new enforcement actions and collected and deposited over $484 million in civil monetary penalties.[4] In addition to these new enforcement actions, the CFTC actively pursued over 100 litigation cases, involving a range of conduct including market manipulation, spoofing, and unlawful use of customer funds.

Highlights of the CFTC review include:

· Insider Trading **–** While the CFTC previously had stated that its market manipulation authority was broad enough to encompass insider trading, there had not been any examples of the CFTC actually pursuing such a case until fiscal year 2016. Specifically, the CFTC entered into two separate settlements with traders accused of engaging in insider trading by using confidential, non-public information obtained through their employment for personnel gain, including front-running the orders of their employers.

· Criminal Actions – The CFTC's update highlights that in addition to the prospect of significant civil penalties, individuals accused of violating CFTC rules and regulations may face criminal charges. For example, in November 2016, a federal court in Chicago ordered a U.K. resident, Navinder Singh Sarao, to pay an approximately $25.7 million civil monetary penalty and disgorge approximately $12.8 million. The Court's order also imposed permanent trading and registration bans against Sarao. Separately, in a related criminal action in the U.S. District Court for the Northern District of Illinois, Sarao pleaded guilty to one count of spoofing and one count of wire fraud in a related criminal action.

· Whistleblowers – In fiscal year 2016, the CFTC paid a whistleblower award of $10 million, the largest award the CFTC has issued since its Whistleblower Program was created in 2010 and the third in the program's history. Pursuant to the CFTC's Whistleblower Program, the CFTC will pay awards to whistleblowers who voluntarily provide information about violations of the Commodity Exchange Act that results in the CFTC bringing an enforcement action and that results in more than $1 million in monetary sanctions. The CFTC also is authorized to make an award based on monetary sanctions collected by other agencies that are related to a CFTC enforcement action. Whistleblowers may become an increasingly important aspect of FERC and CFTC enforcement action. Notably, both FERC's and the CFTC's recent enforcement actions against Total Gas & Power North America, Inc. ("TGPNA") stemmed from tips received from two whistleblowers, former TGPNA employees who separately alerted the agencies to TGPNA's activities. In October 2011, a former trader for TGPNA filed a whistleblower complaint with the CFTC implicating one of the accused traders and certain officers at TGPNA's parent and affiliate companies. Eight months later, on June 3, 2012, a separate employee sent an email to FERC's Enforcement Hotline, followed by a formal whistleblower complaint to the CFTC one week later.

[1] *Maxim Power Corp., et al.*, 156 FERC ¶ 61,223 (2016); *National Energy & Trade, L.P.*, 156 FERC ¶ 61,154 (2016); *In re David Silva*, 156 FERC ¶ 61,155 (2016); *Saracen Energy Midwest,* 156 FERC ¶ 61,122 (2016); *Lincoln Paper and Tissue, LLC*, 155 FERC ¶ 61,228 (2016); *Berkshire Power Co. LLC*, 154 FERC ¶ 61,259 (2016).

[2] *FERC v. Barclays Bank PLC,* No. 2:13-cv-2093 (E.D. Cal.); *FERC v. Silkman*, No. 1:13-cv-13054 (D. Maine); *FERC v. Powhatan Energy Fund LLC*, No. 3:15-cv-00452 (E.D. Va.); *FERC v. City Power Marketing LLC*, No. 15-cv-01428 (D.D.C.); *FERC v. ETRACOM LLC*, No. 2:16-cv-1945 (E.D. Cal.); *FERC v. Coaltrain Energy L.P.*, No. 2:16-cv-00732 (S.D. Oh.); *BP America, Inc. v. FERC*, Dkt. No. 16-60604 (D.C. Cir.).

[3] While the district court in City Power issued an order earlier this year denying a motion to dismiss that appeared to acknowledge that trading in a manner inconsistent with market design could constitute market manipulation in some circumstances, the order did not address the substantive merits of the claims at issue and both of these issue remain unresolved.

[4] While the CFTC reports that it achieved $1.29 billion in monetary sanctions *ordered*, it is likely many of these were default cases in which the CFTC was actually unable to collect the monetary sanctions ordered.