

# The Emerging Law of Energy Manipulation Looks A Lot Like Securities Law

Concentrate On Facts

By Wesley Heath



In FERC's litigated electric manipulation cases, courts are looking to securities law to help fill out FERC's enforcement program, often to FERC's benefit. Early factual development and an interdisciplinary skill set for lawyers will be necessary to defending these cases.

Since 2005, FERC has been building out its enforcement program. A critical aspect has been its litigated cases in federal court where securities law has played a vital role in four areas.

First, a court has considered whether the relationship between energy manipulation and securities law is constrained or flexible. Second, securities law has helped define what conduct is manipulative and what FERC must prove. Third, courts have looked to securities law in deciding if and when FERC can bring cases against individuals. Fourth, securities law has limited the success of attacks on FERC's anti-manipulation rule.

FERC's modern enforcement program traces its origins to the perceived market abuses in the Western Power Crisis in 2000-01. Congress responded with the Energy Policy Act of 2005, much like it passed the Securities Act of 1933 and Securities Exchange Act of 1934 (Exchange Act) to prevent securities market abuses seen as contributing to the Great Depression.

Although FERC has jurisdiction over a number of potential violations, almost all the litigated cases to date have involved allegations of manipulation. Given the relative newness of FERC's enforcement program, this is unsurprising as those cases tend to be the most consequential, complex, and disputed.

Although FERC began its anti-manipulation program with natural gas cases, we do not yet have a court opinion helping to define manipulation in the natural gas context. Under the Natural Gas Act of 1938, FERC has brought cases before in-house administrative law judges with Commission review and appeal to federal appellate courts.

Only one natural gas manipulation case, *Brian Hunter*, has completed this lengthy process, and the federal appellate court rejected FERC's jurisdiction over the alleged manipulation of NYMEX natural gas futures. In contrast, the Federal Power Act of 1935 (FPA) allows for direct enforcement litigation in federal district courts. This key statutory difference, combined with the greater number of FERC electric enforcement matters, has produced a number of federal court opinions.

Although no FERC federal court enforcement case has gone to trial or reached an appellate stage, a picture of the substantive law of energy manipulation is emerging. We are learning it looks a lot like securities law in some important respects. FERC has also been fairly successful when advocating for courts to follow securities

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law. From these early battles, best practices for defending against FERC enforcement litigations and investigations are emerging.

### **Big-Picture Relationship is Still Unclear**

A longstanding question has been whether energy manipulation and securities law enjoy a tight or flexible connection, such as how far can FERC or the courts depart from established securities law in energy manipulation cases? In 2005, Congress directly modeled the FPA's anti-manipulation provision on the one in the Exchange Act with minimal differences.

FERC subsequently modeled its anti-manipulation rule on the corresponding Securities and Exchange Commission (SEC) rule with only minor changes. The FERC rule broadly prohibits an "entity" from "us[ing] or employ[ing] any device, scheme or artifice to defraud," "mak[ing] any untrue statement of a material fact," or "engag[ing] in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity." FERC must also prove intent to commit any fraudulent acts and its jurisdiction.

Importantly, the FPA statutory provision, which sets the permissible boundaries of FERC's anti-manipulation rule, states that the ban on "any manipulative or deceptive device or contrivance" shall have the same meaning as used under the Exchange Act.

Defendants have argued the FPA binds FERC and the courts to follow securities law. FERC has claimed that differences between energy and securities markets and in mission between FERC and the SEC provide discretion to deviate from securities law.

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Only one court, in *FERC v. Coaltrain Energy, L.P. (Coaltrain)*, has considered this issue. The court generally seemed receptive to “manipulative or deceptive” practices under the FPA differing from those under the Exchange Act within limits.

Importantly, it also seemed amenable to FERC’s position that the “difference between the securities and the electricity markets” is relevant in determining whether conduct is manipulative.

This leeway allowed the court to consider conduct “for the purpose of impairing, obstructing, or defeating a well-functioning market” to be manipulative, a definition of manipulation that FERC did not base on securities law.

The court also held that this broad definition did not stray beyond what the FPA allowed. *Coaltrain* is only a single court’s opinion and does not set clear lines, so how far energy manipulation law can depart from securities law remains hazy.

very existence communicates false information such as wash trades or coordinated bidding.

The *Barclays* court rejected the argument that “trades which involve willing counterparties made on the open market cannot be actionable.” Relying on securities law, it found that the alleged scheme of trading physical electricity at a loss to move the market settlement and benefit financial swaps was deceptive as “strategies designed to manipulate prices and deceive purchasers and sellers and which reflect a distorted . . . estimate of the underlying value of the physical products which Defendants were trading.”

Further explaining the difference between manipulative and non-manipulative conduct, the court in *FERC v. City Power Marketing, LLC (City Power)* considered FERC’s allegations that defendants engaged in wash-like trading of congestion products to obtain an incidental revenue stream paid on transaction volumes.

The court emphasized that “the same conduct may or may not be deceptive depending on an actor’s purpose. Securities transactions that would be lawful if based on a genuine belief that the market has mis-valued a security can be unlawfully deceptive if undertaken to obtain some side benefit.”

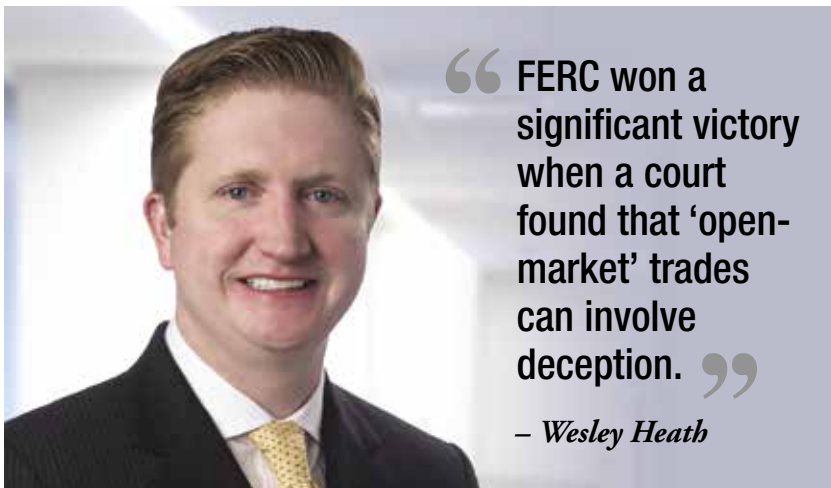
The court continued that “securities traders are not free to trade for whatever purpose they wish. Traders are presumed to be trading on the basis of their best estimates of a security’s underlying value and to trade for other purposes can be deceptive.”

In *Coaltrain*, the court rejected defendants’ attempts to characterize similar allegations as a failure to disclose the purpose of their trades. Instead, it found that FERC’s allegations were “that Defendants manipulated the market by actually *placing the trades* purportedly for the sole or primary purpose of receiving [the] credits.” Like in *City Power*, the *Coaltrain* court, relying on securities law, concluded that otherwise legal conduct may be manipulative if intended to deceive others.

Securities law has also found an important application in setting what FERC must ultimately prove (or not prove) to show manipulation. The *City Power* court agreed with, and the *Coaltrain* court was sympathetic to, FERC’s position that it, like the SEC, does not need to prove a manipulative scheme is financially successful, such as the scheme made money.

### FERC Cases Against Individuals

Securities law has also defined which individuals FERC can pursue. A notable difference between the FPA’s and the Exchange Act’s provisions is that the FPA’s applies to “entities” while the Exchange Act’s applies to “any person.”



### Energy Manipulation Law Requires Deception

Although clarity is lacking on the tightness of energy manipulation to securities law, specific applications of securities law in energy manipulation cases are producing results. The most important has been deciding what conduct is manipulative or deceptive. Relying on the Exchange Act, courts have found the FPA’s anti-manipulation provision to be a broad “catchall” for fraud. However, a number of courts have emphasized an important limitation – what it catches must involve “misrepresentation or deception.”

The *Coaltrain* court found that this is “essential to the common understanding of fraud.” This deception requirement derives from limits courts found on the SEC’s parallel authority a few decades ago.

So far, FERC has successfully pled that the conduct alleged in its manipulation cases was deceptive. In *FERC v. Barclays Bank PLC (Barclays)*, FERC won a significant victory when a court found that “open-market” trades can involve deception.

Open-market trading is bids, offers, or transactions that are generally visible to, and executable by, market participants. The term seeks to draw a distinction from trading that through its

The *Barclays* court relied upon the FPA's overall context and the FPA anti-manipulation provision's reference to the Exchange Act's provision, under which the SEC routinely brings cases against individuals, to find that FERC could do the same. Other courts, including *City Power* and *Coaltrain*, reached the same conclusion.

But securities law has also limited FERC's ability to reach individuals. The FPA and Exchange Act outlaw the "use" or "employment" of a "manipulative or deceptive device or contrivance." In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A. (Central Bank)*, the Supreme Court found that "use" or "employment" did not extend to "giving aid to a person who commits a manipulative or deceptive act."

This decision drew a line between those who "aid or abet" securities violations and those known as "primary violators" who participate directly. Although the SEC subsequently received authority to pursue aiders and abettors, Congress has not given FERC similar authority.

In *Coaltrain*, the court applied *Central Bank* to reject FERC's case against two individuals, finding their involvement extended only to the alleged scheme's "development" or "creation." The court found the allegations against others who allegedly "partook in the decision to execute specific . . . trades" legally sufficient.

Similarly, in *FERC v. Silkman (Silkman)*, the court found that designing a scheme was insufficient but that the alleged facts extended to the scheme's actual employment.

### FERC's Anti-Manipulation Rule

In two cases, defendants unsuccessfully raised arguments regarding the statutory authority for, and constitutionality of, FERC's anti-manipulation rule. The SEC and criminal prosecutors faced similar arguments years ago in securities cases.

First, as already discussed, the *Coaltrain* court rejected the argument that defining manipulation as conduct "for the purpose of impairing, obstructing, or defeating a well-functioning market" exceeded FERC's authority.

The court additionally found this definition consistent with FERC's general mandate to ensure just and reasonable rates. The court seemed more comfortable with this definition, which accompanied FERC's anti-manipulation rule, because the actual text of FERC's rule mirrored the SEC's well-established rule and FERC had indicated its willingness to incorporate securities law precedent depending on the circumstances.

Second, a few defendants have argued that FERC's anti-manipulation rule was "void for vagueness," a concept that invalidates a rule when it does not provide notice of what it prohibits. In *Silkman*, the court found the doctrine of limited applicability because the defendants were sophisticated parties involved in complex markets, and liability "require[ed] not only that a party engage in fraudulent conduct but do so knowing its conduct was improper."

The *Silkman* court evaluated the information available to defendants in finding the alleged conduct contrary to the potentially defrauded demand response program's expressed purpose. In *Coaltrain*, the court rejected the argument based on defendants being sophisticated parties and FERC having to demonstrate intent.

Although *Silkman* and *Coaltrain* are only two courts, the uphill battle these arguments faced is unsurprising given long-standing application of securities fraud prohibitions in both civil and criminal contexts. That is not to say that a broad attack on FERC's anti-manipulation rule could not succeed with different facts or a different court, but defendants should understand the difficulties.

### Best Practices are Emerging

While FERC's electric enforcement program is still relatively young, defendants have yet to

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find a silver bullet for a case that has reached federal court or for the anti-manipulation rule. Early in litigation, a court considers whether FERC has a case if its allegations are true. Later stages that consider whether they are actually true, including potential fact-finding trials before juries, could prove more challenging for FERC.

FERC's survival in these early-stage court challenges provides some lessons for future defendants and even for those still in the investigative stage. A potential defendant's factual development of its positions both in court and in an investigation will be even more critical than it already was.

Those under investigation sometimes opt for a reactive approach, such as doing little more than responding to government requests. That strategy may make sense in low-risk investigations. But making that assessment is not easy, and investigations of potential manipulation are not low risk.

Approaching an investigation reactively may involve initially spending less time reviewing documents and interviewing witnesses. The unintentional result can be an investigative record that does not bring out facts favorable to the company or person being investigated either because they remain unknown or unarticulated.

Ultimately, a reactive approach can make persuading FERC not to move forward or obtaining a favorable settlement more difficult. Moreover, it raises the odds of costly litigation and associated negative publicity. A crucial lesson from the court cases is that outcomes will usually come down to the facts, so

concentrate effort there.

An interdisciplinary skill set for defense lawyers is necessary. On the legal side, a background in investigations and enforcement litigation is merely the starting point. Counsel must also have deep knowledge of securities and commodities manipulation precedents and other relevant fields like antitrust. The next requirement is thorough understanding of areas unique to FERC such as its jurisdiction and basic statutory mandate of just and reasonable rates.

On the industry side, knowledge of products and strategies used in energy markets is critical to cost effective factual

development. Counsel also must understand the similarities and differences of energy markets to securities and commodities markets where courts are looking for analogous legal precedents.

The end result must be combining all these skill sets to determine the best course at the outset and to make prudent adjustments as the investigation or litigation progresses. Enforcement investigations and litigations of potential manipulation can be unpleasant at best. Given the stakes, early investment in factual development and deep counsel expertise are necessary to avoid or mitigate significantly worse outcomes. **PUF**