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Potential Regulatory Gaps In Energy Trading

Law360, New York (March 27, 2009) -- Repeal of the Glass-Steagall Act without commensurate adjustments in regulatory oversight by the various affected regulators may have contributed to the current economic disruptions we are experiencing.

The failure to adjust the regulatory system to reflect changes in the regulated markets created gaps among the jurisdiction and authority of regulators. Systemic hazards arose as the regulatory schema lagged behind the sophistication and complications of the markets and market players.

Similarly, the multiple ongoing cases involving the hedge fund Amaranth Advisors LLC[1], which spectacularly collapsed in 2007 due to its speculative energy trades, have illuminated a potential disjuncture in the regulation of physical and derivative trades in natural gas and electric power.

As Congress mulls the creation of additional tradable energy-related derivatives through a CO2 cap-and-trade system and a national renewable energy standard, attention must be paid to ensuring the regulatory framework for these products is in satisfactory working order. As of today, that is questionable.

Background

The underlying facts shared by these cases are set forth in the findings asserted by the Federal Energy Regulatory Commission ("FERC") in its Order to Show Cause[2] and describe circumstances which expose the gap between the regulatory regimes of FERC and the Commodity Futures Trading Commission ("CFTC").

Whether or not FERC or the CFTC prevail in their assertion of these facts, the situation presented can arise elsewhere and lead to the same potential regulatory gaps. FERC alleged the following:

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5. “... Respondents manipulated the price of Commission-jurisdictional transactions [in the cash natural gas market] by trading in the Natural Gas (“NG”) Futures Contract ... which trading was designed to produce, and in fact produced, artificial “settlement prices” ... for these contracts. ... Respondents manipulated the final, or “settlement,” price of the NG Futures Contract on the above dates by selling an extraordinary amount of these contracts during the last 30 minutes of trading before these futures contracts expired. *** (Show Cause Order, Paragraph 5)

6. “... Amaranth and its traders ... intentionally manipulated the settlement price of the NG Futures Contract knowing that the NG Futures Contract settlement price is explicitly used to price a substantial volume of Commission-jurisdictional natural gas transactions (namely, “physical basis” transactions, described below, and the various monthly indices that are calculated using physical basis transactions). *** Accordingly, the Respondents intentionally or recklessly manipulated prices in connection with Commission-jurisdictional transactions, and thus violated the Commission’s Anti-Manipulation Rule.[3]” (Show Cause Order, Paragraph 6)

FERC readily concedes that Amaranth’s activities in the futures market are exclusively regulated by the CFTC. Indeed, upon discovering questionable activities in the physical markets, FERC staff informed CFTC staff of its suspicions and the two agencies worked hand-in-glove to determine what happened. Each fashioned remedies according to its governing organic statute. The CFTC filed its complaint against Amaranth the day before FERC issued its show cause order.[4]

CFTC Jurisdiction

Prior to the 1974 Commodity Exchange Act amendment creating the CFTC, the U.S. Securities and Exchange Commission (“SEC”) and the states shared jurisdiction over commodity transactions with the Commodities Exchange Authority of the U.S. Department of Agriculture.

Congress gave the new commission exclusive jurisdiction with respect to “accounts, agreements ... and transactions involving the sale of a commodity for future delivery.”[5]

In a series of cases going back to 1976, the courts have upheld CFTC’s grant of exclusive jurisdiction, primarily against attempted incursions by the SEC.[6]

In CME v. SEC, the 7th Circuit wrote: “An instrument either is or is not a futures contract. If it is, the CFTC has jurisdiction, if it is not, the CFTC lacks jurisdiction; if the CFTC has jurisdiction, its power is exclusive.” 883 F.2d. 537 at 548.

There is therefore at least a prima facie case for exclusive CFTC jurisdiction over a case arising from actions taken in the futures markets, regardless of the impact of those actions in other, nonjurisdictional markets.

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FERC Jurisdiction

The natural gas and power markets evolved in the 1980s-1990s from predominantly cost-based regulated entities to less integrated, more competitive companies and FERC was forced to move with those changes from cost-based to behavior-based regulation.

FERC struggled to adapt its regulatory apparatus to the rapidly changing environment. The meltdown of the Western markets, particularly in California, of both commodities in 2000 and 2001 simply highlighted FERC's lagging authority.

Congress remedied FERC's lack of oversight jurisdiction and enforcement authority in the Energy Policy Act of 2005 by bestowing a significant expansion of jurisdiction and remedial authority, which brought FERC's enforcement authority into parity with that of the SEC and CFTC.[7]

FERC's jurisdiction in the energy markets includes, inter alia, wholesale trades in "physical" energy, or energy that will be delivered within two days of trade execution (U.S. Bankruptcy Code definition of "spot" contract) in interstate commerce, (excluding first sales of natural gas), as well as forward trades in a cash market [where delivery is contemplated].[8]

In its Show Cause Order, FERC alleged that the futures market was manipulated to benefit trades in the options market (which is also a futures markets regulated by the CFTC), but that its Natural Gas Act jurisdiction was invoked because the futures market manipulation suppressed the benchmark settlement price of natural gas futures which in turn manipulated and suppressed the price in the physical market which had been pegged, by standard contract provisions, to the prompt month natural gas futures settlement price.

Potential Regulatory Gaps

If the district court endorses Amaranth's view of CFTC jurisdiction as being exclusive, and FERC is denied jurisdiction over the price manipulation which occurred in the physical markets as a direct result (or through 'reckless indifference') and solely due to the manipulation in the futures market, the physical market will have sustained a harm for which there is no remedy.

The CFTC is powerless to remedy a wrong which occurs in a non-jurisdictional market, i.e. the physical market.

A second gap arises, and in this case was apparently unaddressed by FERC, by the impact that natural gas settlement prices have on the daily power settlements, since natural gas is the margin fuel[9] in most of the country and the price of power swings are closely correlated to the swings in the price of natural gas.

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In fact, the correlation is so strong, based upon the heat rate of relevant natural gas fired power plants, that it is referred to and traded as the ‘spark spread.”

However, since FERC apparently did not raise the issue of the impact on the power markets during its investigation of Amaranth’s alleged natural gas market manipulation, it remains another area of potential regulatory gap if FERC is prevented from exercising its jurisdiction to protect the physical natural gas and power markets.

A third, and potentially very problematic gap, arises from the fact that natural gas and power are often traded through use of standardized forward contracts, such as the NAESB and EEI contracts, which have been adopted almost without change as appendices to the ISDA form of agreement.[10]

These contracts are considered to be physical contracts subject to FERC jurisdiction. However, as standardized forward contracts traded on exempt contract markets, they could just as easily be considered futures and brought under CFTC jurisdiction.

Where trading occurs in standardized, fungible contracts absent a contemplation of delivery, some courts have held such activity to be in the nature of futures trading.[11]

The Seventh Circuit has examined this type of issue in the form of foreign currency trading and concluded that the proper analysis lies in whether trading occurs in the “contracts” themselves, or whether trading occurs in the actual underlying commodity.[12]

As trading in the forward market becomes more and more standardized and regulated,[13] and the distinction between futures and forwards continues to fade, competing regulators will need congressional direction to prevent regulatory gaps.

Resolution

The original reason CFTC was given exclusive jurisdiction is as compelling now as it was in 1974, if not more so, due to the global spread of these markets.

Having a single regulator establish and enforce all rules relating to the market allows for the stability and predictability necessary for those markets to thrive.

It makes sense to have a unified enforcement scheme for inherently linked markets, such as energy futures and physical energy, to avoid having to litigate essentially the same issues in two separate fora.

However, unless the two agencies are combined, there will be a potential gap in jurisdiction.

One potential fix for this gap is to leave CFTC as the sole regulator in cases like Amaranth, but allow FERC to present evidence to the CFTC on the damages incurred in

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its markets so that CFTC can seek redress for the cash market manipulation caused by futures trading.

FERC has the authority to not only penalize the manipulator by making it disgorge any ill-gotten gains, but it also has the ability to impose fines of up to $1 million/per day per incident. It is not clear that this authority could be delegated by FERC to the CFTC.

It is also not clear why FERC should have to appear before another agency to present and defend its findings, after having gone through its own investigative proceedings, granting extensive due process, in its adjudicatory proceeding, to be able to present its findings to the CFTC.

Another option is to give the CFTC authority to impose sanctions for any and all damages to the cash market resulting from manipulation and fraud in its regulated futures markets.

Although this would avoid forcing FERC to appear before it, this option would significantly expand CFTC's jurisdiction and simultaneously contract FERC's.

It may require CFTC to hire duplicate investigators and analysts, but result in a less effective regulator due to loss of focus on the energy markets. Politically and functionally, this is not an optimum outcome.

A third option would be for Congress to provide for concurrent jurisdiction in the futures and energy markets. Although this option does not entail many of the disadvantages of the foregoing options, it could easily lead to forum-shopping, the 'race to the courthouse' and counterproductive and unseemly competition between two regulatory bodies, while muddying the jurisdictional waters.

Perhaps an easier fix and the one least disruptive to the markets is for Congress to provide explicitly that FERC has jurisdiction to punish misbehavior which leads to fraud or manipulation in the markets it oversees, no matter where that behavior occurred, even if it occurred on markets subject to the (otherwise) exclusive jurisdiction of the CFTC.

FERC has the right and obligation to protect its jurisdictional markets. While this may require a more limited reading of the traditional 'exclusive jurisdiction' language by the courts and by the CFTC itself, FERC's unqualified position is that it has no interest in regulating futures and the CFTC has no interest in regulating the cash or spot markets.

A county prosecuting a shooting is not encroaching on those who regulate the purchase and sale of guns; the gun was merely the instrument of the wrongful act.

Likewise, where behavior on the futures market has the effect of manipulating the cash market, it is difficult to imagine that FERC is over-reaching where it only seeks redress for the harm to the cash market.

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Whether or not the courts act to bar FERC jurisdiction or Congress acts to clarify the situation, the Amaranth case has demonstrated how well two regulatory agencies, each acting under its own authority, can coordinate their investigations and charges and act quickly to safeguard the markets, without whipsawing the target and creating duplication and waste.

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[1] Amaranth Advisors LLC, Amaranth Advisors (Calgary) LLC, Amaranth Management Limited Partnership and Amaranth Group Inc. v. FERC, Case No. 07-1491, US Ct. App. For DC Cir filed Dec. 6, 2007 (Amaranth appeal of FERC decision in FERC IN07-26); Brian Hunter (lead Amaranth Trader) v. FERC, F.Supp.2d 12 (D.D.C. 2008) (upholding FERC jurisdiction over him personally); and US CFTC v. Amaranth Advisors, LLC, Civil No. 07-6682 (S.D.N.Y. filed July 25, 2007).

[2] Order to Show Cause and Notice of Proposed Penalties, Docket No. IN07-26-000, 120 FERC ¶61,085, issued July 26, 2007.

[3] FERC's Anti-manipulation rule, 18 CFR Part 1c prohibits the use of "any ... scheme ... to defraud or to engage in any act that operates or would operate as a fraud" in FERC's jurisdictional natural gas or power markets. Both the statutory authority, Energy Policy Act of 2005 §§315 and 1283, and Part 1c are patterned on the SEC's anti-fraud provisions.

[4] CFTC & FERC vs Amaranth: Doing the Sister Regulator Act, S. Brown-Hruska and R. Zwirb, Futures and Derivatives Law Report, Oct. 2007, Vol. 27 Issue 9 (noting that the "well-coordinated announcements" were "completely deliberate.") [Quoting from "Big Week at FERC, CFTC," Scudder Publishing Group, August 2007.]

[5] Commodity Exchange Act ("CEA") § 2(a)(1)(A).

[6] See, inter alia, Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989); Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137 (7th Cir. 1982) (options on GNMA mortgage-backed pass-through certificates); SEC v. Univest Inc., 405 F. Supp. 1057 (N.D. Ill. 1975) (London options).

[7] Sections 314 and 315 of the Energy Policy Act of 2005 increased FERC's remedial authority pursuant to the Natural Gas Act and the Natural Gas Policy Act from $5000 or $25,000 to $1,000,000 per violation per day, and gave FERC jurisdiction over "any entity" who employs manipulative or deceptive practices in its jurisdictional markets.

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Sections 1283 and 1284(d) provide the same extension of jurisdiction over 'any entity' and of enforcement authority to FERC under the Federal Power Act. Interestingly, Section 316, providing for Natural Gas Market Transparency Rules, which sets forth FERC's new authority to obtain market information, requires FERC to conclude a Memorandum of Understanding with the CFTC relating to information sharing and explicitly states that "Nothing in this section (i.e., §316) may be construed to limit or affect the exclusive jurisdiction of the (CFTC) under the Commodity Exchange Act." §316(c)(2). There is no comparable provision relating to the power markets.

[8] FERC's jurisdiction is broadly defined as hydropower generation and all facilities for the transmission and sale of wholesale electric power in interstate commerce. See, Federal Power Act § 201, 16 U.S.C. §824.

[9] Since coal and nuclear tend to be used as baseload fuels, and renewables are not yet a large enough percentage of the fuel mix, natural gas tends fuel the generating facilities running 'on the margin,' that are last on the daily dispatch queue and thus set the daily price for power.

[10] NAESB is the natural gas contract created by the North American Energy Standards Board, EEI is the power contract created by the Edison Electric Institute and ISDA is the generic standard forward contract created by the International Swaps and Derivatives Association.

[11] See CFTC v. Co Petro Mktg. Group, 680 F.2d 573 (9th Cir. 1982)(trading with the public in off-exchange gasoline contracts deemed to be illegal futures activity).

[12] CFTC v. Zelener, 373 F.3d. 861 (7th Cir. 2004).

[13] The U.S. House of Representatives Committee on Agriculture recently reported a bill that would curtail certain energy commodity exemptions and increase oversight over exempt commercial markets, both of which had been granted exemption in the Commodities Futures Modernization Act of 2000.

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