New York Law Journal

A NEW YORK LAW JOURNAL SPECIAL SECTION

An ALM Publication

White Collar Crime

WWW.NYLJ.COM

TUESDAY, OCTOBER 11, 2011

Energy Markets: Enforcement in an Age of Rising Prices

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WITH THE SURGE in energy prices over the past few years, as well as the perceived increase in trading volatility, regulators have fixed their sights on potential fraud and manipulation in the energy markets. Some of these efforts, such as the Department of Justice's creation of an Oil and Gas Price Fraud Working Group, have received significant public attention, despite the fact that it remains unclear whether—and how—this will actually impact oversight of the markets.

Less attention has been given to the work that already has been undertaken by the Commodity Futures Trading Commission (CFTC), the Federal Energy Regulatory Commission (FERC), and other law enforcement officials to police the energy markets—efforts that have led to turf battles between regulators competing to assert their jurisdiction in this arena. Less attention also has been given to the overlap between these enforcement activities and regulators' parallel efforts to determine whether structural forces are impacting commodity pricing. It remains to be seen whether the Working Group will help streamline and coordinate these efforts, or whether the heightened interest in this area will generate yet more jurisdictional struggles and duplicative inquiries.

The Working Group

On April 21, 2011, Attorney General Eric Holder announced the creation of the Working Group within the existing Financial Fraud Enforcement Task Force. Comprised of representatives from the Department of Justice, the CFTC, the National Association of Attorneys General, the Departments of Agriculture and Energy, and several other federal agencies, its stated purpose is to investigate "whether there is any evidence of manipulation of oil and gas prices, collusion, fraud, or misrepresentations at the retail or wholesale levels that would violate state or federal laws," as well as to examine "investor practices, supply and demand factors, and the role of speculators and index traders in oil futures markets."[1]

The Working Group's formation likely was intended, at least in part, as a signal to market participants that prosecutors will be paying close attention to their activities, and to reassure the public that the government is actively monitoring the energy markets. Other than the attorney general's memorandum announcing its formation, however, there has been no public guidance regarding the Working Group's activities.

The Working Group also seems to have failed to include several relevant regulators and law enforcement agencies. For example, despite the significant role that the New York County District Attorney's Office has played in investigating commodities fraud, and its frequent collaboration with the CFTC on noteworthy investigations, the Working Group does not appear to include representatives of that office.[2] It likewise is not clear whether the Working Group will include representatives of FERC, which has principal jurisdiction over the physical delivery of natural gas and the transportation of oil by pipeline in interstate commerce.

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Cops on the Energy Beat

Whatever the reasons for the Working Group's creation, it is clear that regulators were already focused on the energy markets. If there is a larger theme here, it is one of intense competition among regulators rather than inattentiveness.

The Commodity Exchange Act (CEA) grants the CFTC exclusive jurisdiction over the trading of futures and options on futures, including energy products such as crude oil, heating oil, natural gas, and gasoline.[3] Traditionally, to prove market manipulation, the CFTC was required to establish that a trader caused an artificial price, and specifically intended to do so. Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act substantially expanded that authority to prohibit fraud and attempted manipulation more generally, even in the absence of an artificial price. CFTC Rule 180.1, which took effect on Aug. 15, 2011, is modeled after SEC Rule 10b-5, and contemplates liability where the CFTC can prove recklessness on the part of the defendant.[4]

The CFTC has not yet announced any energy-related enforcement action under Rule 180.1, but even under the prior law it has been active in this area. In May 2011, the CFTC charged Parnon Energy Inc., Arcadia Petroleum Ltd., Arcadia Energy (Suisse) SA, and two traders with unlawfully manipulating and attempting to manipulate the crude oil market.

Specifically, the CFTC alleged that the traders accumulated a substantial position of physical crude oil although they had no commercial need; contemporaneously purchased a long position of crude oil derivatives on two futures exchanges to artificially inflate crude oil prices; held the physical position to give the impression to other market participants that crude oil supplies were tight in order to artificially inflate the price as they sold their long derivatives position; sold short a second position of crude oil derivatives at artificially high prices; and then surprised the market by selling their physical position to drive down crude oil prices, thereby increasing the value of their short position.[5] According to the CFTC's Complaint, one trader allegedly e-mailed other traders that there was

> "money to be made shorting" NYMEX [crude oil] calendar spreads *if* the rest of the market *believes* supplies…are tight, but someone unexpectedly turns the end-of-month balance into a "surplus."[6]

CFTC v. Parnon Energy Inc. et al. shares several key features with other recent CFTC energy-related cases. For example, in 2008 the CFTC brought an enforcement action against Optiver Holding BV, two of its subsidiaries, and several high-ranking employees, accusing them of engaging in a manipulative practice known as "banging the close" or "marking the close." The CFTC accused the defendants of accumulating a large net position of futures contracts and then trading a significant volume of futures contracts in the opposite direction of that position before and during the close of the contracts, impacting settlement prices for contracts in crude oil, heating oil, and gasoline.[7]

Likewise, in a 2007 settlement with Marathon Petroleum Company LLC, the CFTC alleged that Marathon had purchased NYMEX oil futures as part of a scheme intended to drive down the price of physical oil, thereby potentially benefitting Marathon as a net purchaser of foreign crude oil.[8] As in *Parnon*, the CFTC has paid particular attention to energy traders whose large-scale trading on one side of the market stands to benefit even larger, offsetting trades in related products.

Perhaps the best example of this type of case—and of competition between regulators—is the CFTC's enforcement case against Amaranth Advisors LLC and its trader, Brian Hunter. In an enforcement action initiated in July 2007, the CFTC alleged that Hunter had attempted to manipulate the price of NYMEX natural gas futures by dumping large numbers of contracts shortly before closing. By "smashing the close," the CFTC alleged, Hunter and Amaranth were trying to drive down the settlement price for natural gas contracts, thereby benefitting Amaranth's much larger "short" position held in financially-settled swaps.[9]

The day after the CFTC filed its enforcement action, FERC filed its own administrative action based (with some exceptions) on the very same conduct. FERC, which does not have jurisdiction over the futures markets but oversees the physical market for natural gas, alleged that defendants' manipulative scheme had affected the price of FERC-jurisdictional natural gas transactions in violation of §4A of the Natural Gas Act.

In seeking to exercise its jurisdiction, FERC sought to rely on enhanced powers granted to it in 2005 to prohibit manipulation. Section 315 of the Energy Policy Act of 2005 added §4A to the Natural Gas Act, which prohibits "any entity" from engaging in conduct prohibited by FERC "in connection with" the purchase or sale of natural gas or natural gas transportation services "subject to the jurisdiction of [FERC]."[10]

Because the scheme alleged by FERC and the CFTC only involved natural gas futures, and not the trading or delivery of physical natural gas, Hunter sought to challenge FERC's jurisdiction in a proceeding before the U.S. Court of Appeals for the District of Columbia. The CFTC intervened, arguing that Congress had granted it exclusive jurisdiction over trading on futures exchanges.[11]

FERC countered that, under §4A, any individual or entity that engages in manipulation that is found to be "in connection with" a jurisdictional transaction becomes subject to FERC's anti-manipulation authority.[12] In other words, because Hunter's alleged futures-related misconduct purportedly impacted the sales price for contracts for the delivery of natural gas, FERC contended that Hunter (and Amaranth) became subject to FERC's jurisdiction.

The Court of Appeals denied Hunter's petition, holding that FERC's underlying order exercising jurisdiction over Hunter was not a reviewable final agency action.[13] On April 11, 2011, FERC ordered Hunter to pay a $30 million civil penalty.[14] Hunter's pending challenge to that ruling has renewed the jurisdictional arguments previously raised before the Court of Appeals, but FERC's position has not yet been judicially tested. The CFTC's case against Hunter remains pending in the U.S. District Court for the Southern District of New York, where a motion for summary judgment remains sub judice.[15]

Coordination and Conflict

Given FERC's expansive reading of §4A, it is difficult to conceive of a case involving energy futures that would be immune to the type of jurisdictional squabbles experienced in *Amaranth*. To avoid such battles going forward, §720 of the Dodd-Frank Act required FERC and the CFTC to enter into a Memorandum of Understanding by the end of January 2011 delineating their respective authority and resolving conflicts concerning their jurisdiction. However, the agencies missed that deadline and do not appear to have released any such memorandum as of yet. It is unclear whether this is due to continuing disagreement or the press of other matters.

FERC's intrusion into areas traditionally regulated by the CFTC is not the only complicating factor here. The Federal Trade Commission (FTC) has adopted its own rule, modeled on Rule 10b-5, prohibiting manipulation and deceptive conduct in the petroleum markets.[16] On April 6, 2011, the FTC entered into a Memorandum of Understanding with the CFTC delineating the agencies' respective jurisdiction and their sharing of non-public information concerning their investigations.

To date, the FTC has not announced any enforcement action under this rule. However, it did launch an investigation in June 2011 to determine whether there are anticompetitive, manipulative, or fraudulent practices in the petroleum industry.[17] The FTC has not released any additional information regarding that investigation.

The conclusions reached by the FTC in a September 2011 Staff Study, as well as the tension between prior CFTC-sponsored studies and more recent agency action, illustrate the continuing uncertainties here. Although some commentators have assumed that increased "speculation" in the oil and gas markets is responsible for increased trading volatility and higher prices, the FTC's report concludes that this link remains uncertain. Noting that there is "little consensus" in academic studies regarding the existence of a link between higher volumes of futures trading and spot prices for crude oil or other commodities, the FTC report specifically resists any conclusion that increased speculation in the futures markets is responsible for increased energy prices.[18]

The FTC's observations are consistent with a July 2008 Interim Report on crude oil previously issued by a CFTC task force, which concluded that the increase in oil prices between 2003 and 2008 were "largely due to fundamental supply and demand factors," as opposed to position changes by energy traders in the futures markets.[19]

By contrast, recent comments by CFTC Commissioner Bart Chilton and others at the CFTC have suggested the altogether different conclusion that there is a "cause-and-effect" relationship between the trading activities of "new speculators" and the increase in energy commodity prices in 2008.[20] Indeed, included as a stated rationale for recent CFTC regulations imposing position limits on various futures contracts and their economically equivalent derivatives (including crude oil and natural gas) was the contention that restricting the size of traders' positions would in turn "reduc[e] the undue burdens arising from excessive speculation and manipulation."[21]

In sum, while there is intense public interest in the energy markets and competition among regulators to police those markets, there appears to be little consensus about the root cause(s) of the price increases that have fueled that interest. How this will impact the marketplace itself, and whether the Department of Justice's Working Group will help regulators approach these issues with a consistent and efficient approach, are uncertain. And from the perspective of market participants, competition among federal and state regulators seeking to lay claim to energy-related cases may create additional pressure to bring more ambitious cases—imposing higher costs for commodity and other traders as they confront competing agencies regarding the same underlying conduct.

1. Memorandum from Attorney General to Fin. Fraud Enforcement Taskforce (April 21, 2011), available at http://www.justice.gov/ag/AG_Memo_to_FFETF-Gas_Prices.pdf.

2. See CFTC Release No. 5480-08, CFTC Sanctions Two NYMEX Brokers for Fraudulent Trade Practice Schemes in Joint Investigation with NY County District Attorney's Office (April 8, 2008). One of the authors represented an individual in connection with a different joint investigation by the CFTC and District Attorney into energy-related trading.

3. See 7 U.S.C. §2 (2010).

4. See Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,410 (July 14, 2011) (to be codified at 17 C.F.R. pt. 180).

5. Complaint, *CFTC v. Parnon Energy Inc. et al.*, No. 11 CV 3543 (WHP) (S.D.N.Y. May 24, 2011).

6. Id. at ¶24 (emphasis in original).

7. Complaint, *CFTC v. Optiver US, LLC et al.*, No. 08 Civ. 6560 (S.D.N.Y. July 24, 2008).

8. Order Instituting Proceedings Pursuant to Sections 6(c), 6(d), and 9(a)(2) of the CEA, Making Findings and Imposing Remedial Sanctions, *In re Marathon Petroleum Co. LLC*, No. 07-09 (CFTC Aug. 1, 2007).

9. Complaint, *CFTC v. Amaranth Advisors, LLC et al.*, No. 07 Civ. 6682 (S.D.N.Y. July 25, 2007).

10. See 15 U.S.C. §717c-1.

11. Brief of Intervenor CFTC, *Hunter v. FERC*, No. 10-1017 (D.C. Cir. July 16, 2010).

12. Brief of Respondent FERC at 6, *Hunter v. FERC*, No. 10-1017 (D.C. Cir. Sept. 16, 2010); see Prohibition of Energy Market Manipulation, 71 Fed. Reg. 4,244 (Jan. 19, 2006) (to be codified at 18 C.F.R. pt. 1c).

13. *Hunter v. FERC*, No. 10-1017, 2010 WL 5341883, at *1 (D.C. Cir. Dec. 22, 2010).

14. Order Affirming Initial Decision and Ordering Payment of Civil Penalty, *Brian Hunter*, 135 FERC ¶61,054, at 3 (April 21, 2011).

15. In August 2009, the CFTC entered into a consent order with the Amaranth entities imposing a $7.5 million penalty. FERC simultaneously announced its settlement with the Amaranth entities and another trader.

16. See 16 C.F.R. pt. 317 (2011).

17. Information to be Publicly Disclosed Concerning the Commission, Petroleum Industry Practices and Pricing Investigation, File No. 111 0183 (June 20, 2011), available at http://www.ftc.gov/os/2011/06/110620petroleuminvestigation.pdf.

18. FTC, Bureau of Economics, Gasoline Price Changes and the Petroleum Industry: An Update 18-23 (September 2011).

19. Interagency Task Force on Commodity Markets, Interim Report on Crude Oil 3, 27, 31 (July 2008).

20. Bart Chilton, "Opening Remarks to the Futures Industry Association's Panel Discussion: Financial Investors' Impact on Commodity Prices" (March 16, 2011), available at http://www.cftc.gov/pressroom/speechestestimony/opachilton-41.html.

21. See Position Limits for Derivatives, 76 Fed. Reg. 4,752, 4,764 (Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 1, 150 and 151).