



# ***Implementing Dodd-Frank through the Federal Rulemaking Process***

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Vice President

*Energy Bar Association, Financial Reform Legislation (Dodd Frank) Title VII and Its  
Impact on Hedging by Energy Companies*

November 16, 2010

# D o d d *-Frank Articulates the General Intent of Congress, But...*



- Important decisions about crafting the specific rules and regulations with respect to the reformed regulatory structure have been delegated to several financial regulatory agencies including:



Securities and Exchange Commission (SEC)



Commodity Futures Trading Commission (CFTC)



Board of Governors of the Federal Reserve System (BOG)



Office of the Comptroller of the Currency (OCC)



Federal Deposit Insurance Corporation (FDIC)



Federal Bureau of Consumer Financial Protection (BCFP)



Office of Financial Research (OFR)

# ***Dodd-Frank Requires the Adoption of Nearly 250 Rules and Regulations (Nearly 100 At SEC Alone) Governing:***



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- Over-the-counter derivatives
- Central counterparty clearing
- Capital and margin requirements
- Disruptive trading practices
- Leverage
- Position limits
- Hedge funds
- Credit rating agencies
- Anti-manipulation enforcement
- Systemic risk monitoring

T h e ***Federal Rulemaking Process for  
The Dodd-frank Rulemakings Is Likely  
To Be Contentious***



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- First round of battles for the Dodd-Frank rulemakings will take place at the regulatory agencies
- Second round of battles may ensue if adopted rules are challenged in court

# ***The Federal Rule-making Process Is Governed By the Administrative Procedures Act (APA)***



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- The APA requires that federal regulatory agencies adequately justify their exercise of rulemaking authority (not “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law”)
- The APA provides for public participation in the rulemaking process
- The APA sets up a process of judicial review for rules and regulations adopted by regulatory agencies



# ***S.E.C. Rules***



- *Chamber of Commerce of U.S. v. S.E.C.*, 412 F.3d 133 (D.C. Cir. 2005), and 443 F.3d 890 (D.C. Cir. 2006)
- *Am. Equity Investment Life Ins. Co. v. S.E.C.*, 572 F.3d 923 (D.C. Cir. 2009), and 2010 WL 2813600 (D.C. Cir. July 12, 2010)
- *NetCoalition v. S.E.C.*, 2010 WL 3063632 (D.C. Cir. August 6, 2010)
- U.S. Chamber of Commerce and Business Roundtable petition for review of proxy access rules (Sept. 29, 2010)



- Regulator's economic arguments need to be adequately supported—vigorous assertion is not a substitute for rigorous economic analysis
- The goal posts have moved as comments in the public record have become more sophisticated
- Applies to any federal rulemaking governed by the APA

# ***Comments are Being Directed to Two Audiences***



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- Members of the regulatory commission involved in adopting rules
- Judges who may be involved in reviewing challenges to the rules

# ***Critical Component of the Rulemaking Process***



- The outcome of recent court challenges to federal rules have turned on the adequacy of the economic support considered by regulators when they adopted new rules
- Therefore, parties submitting comments are paying particular attention to the quality of their economic arguments and supporting empirical evidence

# *How Can Economic Analysis Affect the Process?*



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- Engages the economics staff within the regulatory commission. These staff members can offer a separate perspective from that of the rule drafters
- Leads regulator to consider and respond to economic analysis and evidence
- Leads regulator to provide a transparent appraisal of the trade-offs and related facts about the impact of a proposed rule
- Failure to adequately consider on-the-record economic arguments leaves the adopted rule vulnerable to a court challenge on the grounds that the regulator's action lacked a reasoned basis



- The meaning of cost-benefit analysis is not universally shared among regulators
  - A broader interpretation goes beyond what is readily quantifiable to include qualitative factors associated with a proposed rule
    - Identifying trade-offs, potential effects and side effects of regulatory actions
    - Identifying potential changes in behavior by market participants resulting from proposed regulatory actions
    - Clarifying the problem the proposed rule is aimed at solving
    - Showing why a rule would, or would not, improve upon the status quo
    - Comparing the effects of the proposed rule with alternative rule specifications, or market-based solutions, aimed at addressing the same problem

# Examples of Dodd-Frank Rulemakings Likely to Affect Energy Companies



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- Title VII Section 747 of Dodd-Frank amends section 4(c) of the Commodity Exchange Act to direct the CFTC to prohibit three specified trading practices deemed by congress to be disruptive.
- The amended section 4(c) also provides the CFTC with the authority to prohibit other trading practices that, in the Commission's judgment, are disruptive of fair and equitable trading.
- Section 747 also makes it unlawful for any person to enter into a swap knowing, or acting in reckless disregard of the fact, that its counterparty will use the swap as part of a device, scheme, or artifice to defraud any third party.



# Examples of Dodd -Frank Rulemakings Likely to Affect Energy Companies



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Continued...

- Section 747 makes it unlawful for any person to engage in any trading, practice or conduct on or subject to the rules of a registered entity that—
- (A) violates bids or offers;
- (B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or
- (C) is of the character of, or is commonly known to the trade as, “spoofing” (bidding or offsetting with the intent to cancel the bid or offer before execution).



# Examples of Dodd-Frank Rulemakings Likely to Affect Energy Companies



Continued...

Title VII requires that swap dealers and major swap participants (MSPs) be subject to capital requirements, margin (collateral) requirements, and conduct regulation.

Title VII MSP determination is based on:

- Whether an entity holds a “substantial position” in any major swap category, excluding positions held for “hedging or mitigating commercial risk”
- Whether the swaps held by the entity create “substantial counterparty exposure”
- Whether the entity is “highly leveraged relative to the amount of capital it holds” **and** has a “substantial position” in any major swap category

E x a m p l e s o f D o d d **-Frank Rulemakings**  
**Likely to Affect Energy Companies**



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*Continued...*

For each MSP Category, a determination of whether an end-user's swap positions are of a magnitude to pose risk to the financial system is key to the regulatory decision as whether to regulate that end-user as an MSP

Under Dodd Frank, an entity or enterprise subject to regulation as systemically important under Title 1 may or may not be required to be regulated under Title XII

A "substantial position" is defined at a "threshold that the Commission determines to be prudent for the effective monitoring, managing and oversight of entities that are systemically important or can significantly impact the U.S. financial system. In setting the definition, the Commission must consider whether the contract is cleared or uncleared, and may take into consideration the value and quality of collateral held against counterparty exposures." Excludes "positions held for hedging or mitigating commercial risk."

How does one define "substantial counterparty exposure"

How does one define "highly leveraged relative to the amount of capital it holds"



- The notice and comment rulemaking process is increasingly viewed by affected firms as an opportunity to place on the public record factual information about:
  - Likely compliance costs with proposed rules,
  - Suggested alternative means of meeting the objectives of regulators, and
  - Providing data and analysis that addresses the issues before regulators
  
- Affected firms are contributing to the public record not only to assist regulators in their deliberations, but also to assist judges who may be asked to review the record in case rules are challenged in court



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# Financial Reform Legislation: Dodd Frank

## Title VII and Its Impact on Hedging by Energy Companies

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Presentation to Energy Bar Association

EBA Finance and Transactions, Generation and Marketing, and  
Legislation Committees, Washington, DC

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# Title VII of the Dodd-Frank Act



- Dodd-Frank fundamentally restructures the over-the-counter (OTC) markets:
  - Removes or alters prior regulatory exemptions for OTC derivatives, including energy derivatives
  - Provides CFTC authority to impose a regulatory framework on OTC derivatives similar to exchange-traded assets
- Major provisions of Dodd-Frank Act applying to derivatives that are set to impact the energy markets:
  - Clearing and exchange-trading
  - Margin and capital requirements
  - Business conduct standards
  - New manipulation authority



# Key Provisions of Title VII: Defining the Market

- Incredibly broad definition that includes (among other things)—
  - Options, with certain exclusions
  - Any agreement, contract, or transaction that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence
  - Swaps
  - Security-based swap agreements (e.g. CDS)
- Excludes sales of a nonfinancial commodity or security for deferred shipment or delivery, as long as the transaction is ***intended to be physically settled***

# Eligible Contract Participants



- “Eligible Contract Participant” is defined as an entity trading for its own account, including:
  - financial institutions,
  - certain insurance companies,
  - certain investment companies,
  - regulated commodity pools of \$5 million or more,
  - an entity
    - that has total assets exceeding \$10 million,
    - the obligations of which are supported by an entity that has total assets exceeding \$10 million or otherwise qualifies as an eligible contract participant under certain other criteria of the definition, or
    - that has a net worth exceeding \$1 million and enters into a contract or transaction in connection with the conduct of its business or to manage the risk associated with its assets or liabilities,

# Potential Economic Questions and Impacts



- Regulators must define what constitutes “substantial” for purposes of determining who is a Major Swap Participant
- Regulators must now determine what we mean by counterparty exposure, develop a metric for identifying and quantifying it, and seek to measure it
- May pull end-users in who were expected to be excluded (unless substantial hedging and market activity)
- Costs associated with registration and compliance:
  - Clearing requirements depending on where the line is drawn
  - Increased capital/margin requirements
  - Business conduct standards (fraud and manipulation, position limits, etc.)



# Key Provisions of Title VII: Clearing

# Clearing



- Swap must be cleared if:
  - In energy, CFTC determines that it is required to be cleared; and
  - Clearing organization accepts it for clearing
    - If no clearing house accepts it, regulator is authorized to take action determined to be necessary and in the public interest, including imposing margin and capital requirements on the parties
- Determination can be for any single swap, or any group, category, type, or class of swaps
- CFTC reviews conducted “on an ongoing basis”
  - At least 30-day public comment period
  - CFTC must make its determination within 90 days after submission, unless clearing organization agrees to an extension
- Implicitly puts CFTC back in the business of contract approval

# How Is Risk Managed Today?



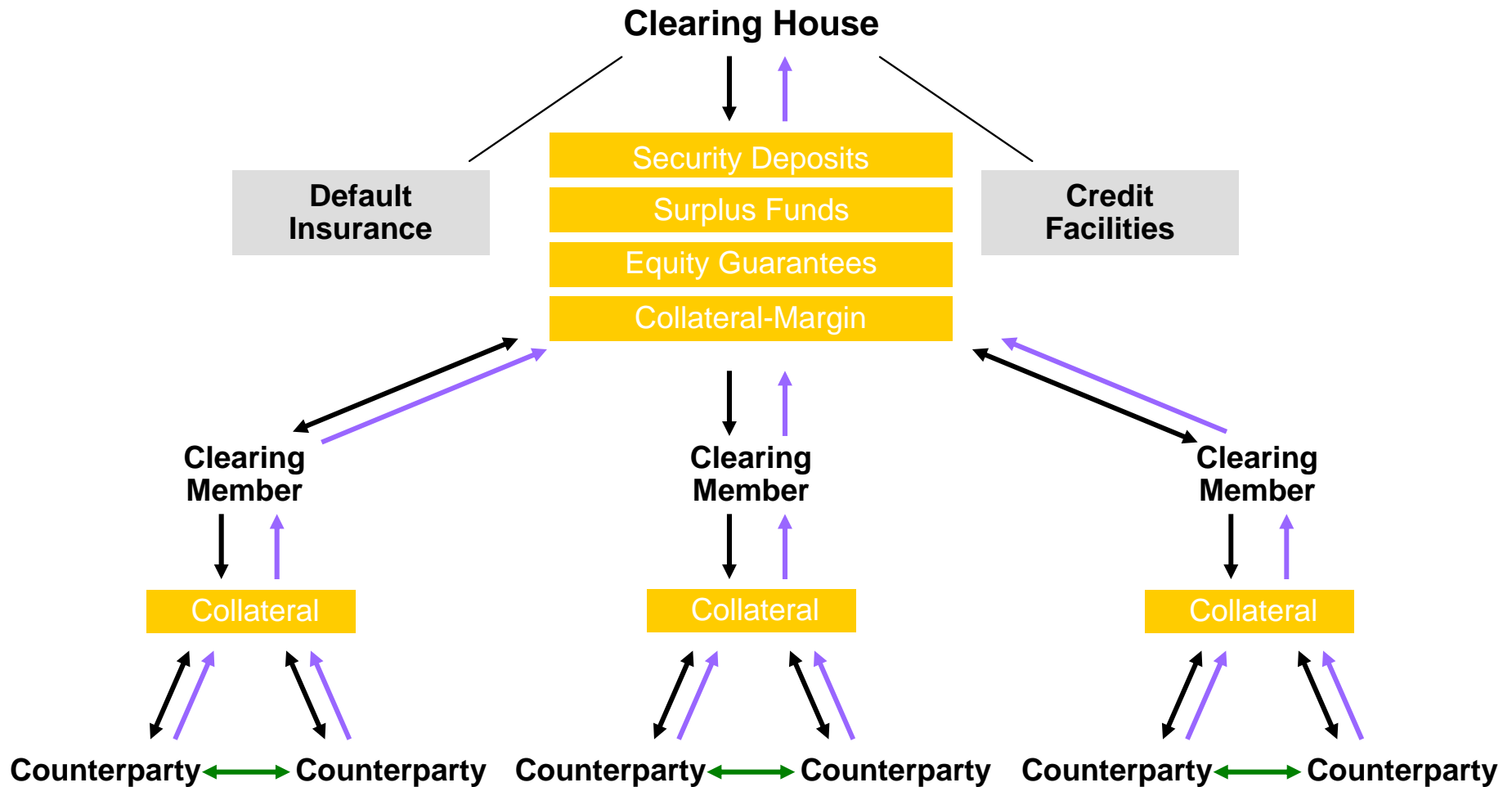
- Forward contracts, contracts with embedded derivatives, swaps
- ISDA Master Agreements and Credit Support Annex
  - Payment Netting
  - Bilateral Collateral Arrangements
  - Close-out Amount in the Event of Early Termination

# Moving From Bilateral to Multilateral Risk Management



- Increased use of collateral and margin
- More frequent marking-to-market based on “warehoused” information in “data repositories”
- Increased mechanisms for bilateral and multilateral netting of contracts, across counterparties, across products, across time
- Portfolio compression and payments through a central structure

# Central Counterparty Clearing for OTC Derivatives



# Centralized Clearing of OTC Contracts



- **Current initiatives (i.e., CME's Clearport and ICE)**
- **Contract standardization issues**
- **Valuation issues**
- **Margin and collateral Requirements**
- **Capital requirements for clearing members (FCMs)**
- **Requirements for segregated funds**

# Exception for Commercial Hedging



- Mandatory clearing requirement does not apply if one of the parties
  - Is not a “financial entity”;
  - Is using swaps to hedge or mitigate commercial risk; and
  - Notifies the applicable regulator how it generally meets its financial obligations associated with entering into non-cleared swaps

# Economic Implications of Requirements



- Many economists regard the clearing requirement to be the most costly with effects predicted on:
  - The number and types of derivatives contracts done
  - Contract liquidity and cost of using derivatives
  - Potential for increased “unhedged” and basis risk
  - Increases in balance sheet risk for financial entities
  - Increases in risk for market users and their customers
  
- Regulators must conduct review to determine which products must be cleared.

# Impact on Market Quality



- As a practical and economic matter, what are the characteristics that they should or may consider in making such a determination and how will they do so objectively?
  - Potential considerations include:
    - Liquidity
    - Market size
    - Scalability
    - Process
  - Again, these must be defined and a metric developed for determining their importance



# Margin and Capital Requirements

# Margin Requirements



- Swap dealers and MSPs will be subject to initial and variation margin requirements for non-cleared swaps
- To “offset the greater risk” to swap dealers, MSPs and the financial system for non-cleared swaps, the margin requirements shall—
  - Help ensure the safety and soundness of the swap dealer and MSP; and
  - **Be appropriate** for the risk associated with the non-cleared swaps held as a swap dealer or MSP

# Grandfathering and End User Exemptions



- Whether margin requirements apply to existing contracts still under consideration by CFTC
- **No end user exception to margin requirements in Dodd-Frank**
  - Senate bill provided an exception to the margin requirements if one of the counterparties is a commercial end user
  - Act does not appear to have this exception, though it could be implemented via rulemaking
- June 30<sup>th</sup> Dodd/Lincoln letter seeks to address concerns regarding margin requirements for end-users

# Economic Impact of Margin Requirements



- Regulators could impose strict margin requirements – initial and variation margin, daily mark-to market
- Daily marking to market greatly increases the cost of hedging for many types of hedges
- Increased margin requirements likely to discourage many types of trading, including hedging and risk management by commercial entities
- Complex implementation with some end users electing not to clear and if they clear, ability to specify which DCO – mismatched book
- Reduction in the availability and liquidity of non-cleared or customized contracts (since potentially increased margin)
- Deterioration of risk management, increased basis risk, as some hedgers move from non-cleared to cleared, or cease to hedge altogether

# Capital Requirements



- Swap dealers and MSPs will be subject to minimum capital requirements
  - In setting capital requirements, must consider risks associated with other types of swaps or classes of swaps or categories of swaps engaged in and the other activities conducted by that entity
  - In addition, the Senate bill required that capital requirements be “substantially higher” for non-cleared swaps (and rulemakings are expected to reflect that legislative intent)

# Economic Effects of Increased Capital Requirements



- Potential for reduced cash available for investment and credit extension
- Lower volumes and reduced liquidity for derivatives contracts, potentially impacting exchanges, as well as in various markets in which swaps dealers operate
- Increased volatility of cash balances
- The potential for higher costs to be passed thru to customers and end users

# Regulation of Clearing Houses And Systemic Risk



- A related question is whether the clearing requirement results in increased systemic risk, by mutualizing it and concentrating in the clearinghouse
- Regulators will now be responsible for ensuring the safety and soundness of the clearinghouses
- Regulatory requirements for clearinghouses include satisfaction of core principles governing financial resources, risk management, settlement and default procedures, governance, antitrust, etc.
- Study and analysis regarding these provisions, as applied to the clearing of OTC derivatives that had their own standards for settling contracts and managing risk, will be necessary

# Swap Execution Facilities



- If a swap is subject to the clearing requirement, it must be executed on an exchange or swap execution facility (SEF)
  - Exception if no exchange or swap execution facility makes the contract available for trading
  
- SEFs—
  - Trading system or platform for multiple participants to execute or trade swaps by accepting bids and offers of participants
  - Not a “contract market” or “national securities exchange”



# Position Limits

# New Position Limit Regime



- Aggregate position limits would be broader than existing or CFTC-proposed position limits because both exchange and OTC positions would be included
  - Unclear how non-cleared swaps would be included in position limit calculations
    - The law directs regulators to focus on “significant price discovery” contracts in determining what are open positions
    - Reporting of positions to regulator or swaps data repositories

# The Resurrection of Position Limits (Back to Future: 1936)



- Act harkens back to 1936 statute which states that the CFTC “shall impose limits on trading and positions as necessary”
  
- Potential side effects on market quality:
  - Impede price discovery by preventing traders from taking positions that optimize their information and their trading strategy
  - Decrease market efficiency
  - Increase market volatility and impedes convergence
  - Harm liquidity and increase hedging costs
  - Cause traders to migrate to markets without position limits

# CFTC to Consider Four Factors



- To the extent it imposes limits, CFTC must balance four factors in setting those limits
  - Prevent excessive speculation
  - Deter price manipulation
  - Ensure market liquidity
  - Avoid disrupting price discovery

# Position Limits on Economic Equivalents



- CFTC’s position limit powers apply to swaps that are **economically equivalent** to futures and options
- Position limits on swaps and futures and options must be imposed simultaneously and concurrently
- Umbrella limits could apply to all futures, including linked foreign futures, options and swaps
- However, while the umbrella limits may apply to “significant price discovery function” swaps, not necessarily to economically equivalent swaps

# Bona Fide Hedge Exemptions



- Bona fide hedge positions are exempt from position limits
  - Current law provides for bona fide hedge exemptions
  - CFTC may require a showing of substitution for physical contracts
- CFTC, however, has broad-based exemption powers for futures and swaps
- CFTC can exempt positions that are “economically appropriate” to reduce a person’s price risk



# Business Conduct Standards

# Business Conduct Standards



- Swap dealers and MSPs will be subject to new business conduct standards to be adopted by regulators
  - Fraud, manipulation, and other abusive practices involving swaps
  - Diligent supervision of the swap dealer's or MSP's business
  - Adherence to position limits
  - Require swap dealers and MSPs to disclose:
    - Information about the material risks and characteristics of the swap
    - Any material incentives or conflicts of interest
    - The daily mark for non-cleared swaps

# New Manipulation Standard



- Prior to Dodd Frank, legal standard for “manipulation” required intent to affect prices
- The Act adds a securities or 10(b)-5 standard:
  - Now unlawful for “any person, directly or indirectly, to use or employ, or attempt to use or employ ... any manipulative or deceptive device or contrivance....”
  - Legislative history reflects an intent to lower the burden of proof
- The manipulation standard applies to all transactions in interstate commerce, swaps, and futures contracts

# Current “Price Based” Manipulation Standard



- Perfected Manipulation
  - Ability to influence market prices
  - Specific intent to do so
  - “Artificial” prices existed
  - The accused caused the artificial prices
  
- Attempted Manipulation
  - Intent to affect market prices
  - An overt act in furtherance thereof

# Fraud Based Manipulation



- Under its new authority, CFTC is developing fraud-based (10b-5 type) rules that prohibit “fraudulent and manipulative behavior.”
- New CEA section 6(c)(1) creates a prohibition against any person using or attempting to use any manipulative or deceptive device or contrivance.
- No longer requires specific intent, but merely required to prove recklessness
- The Commission must promulgate an implementing rule within one year.

# Double Jeopardy: CFTC and FERC



- Energy swaps potentially subject to CFTC or Federal Energy Regulatory Commission (FERC) jurisdiction, or both CFTC and FERC jurisdiction
- The CFTC and the FERC have up to 180 days after the date of enactment of the Act to negotiate a memorandum of understanding to establish procedures for resolving conflicts concerning overlapping jurisdiction between the two agencies
- The Act specifically provides that it does not affect any statutory authority of the FERC or a State with respect to an agreement, contract or transaction that is entered into pursuant to a tariff or rate schedule approved by the FERC or a State regulatory agency so long as such agreement, contract or transaction is:
  - not traded or cleared on a registered entity or trading facility; or
  - if it is traded or cleared on a registered entity or trading facility, such registered entity or trading facility is owned or operated by a regional transmission organization or independent system operator

# FERC's 10b-5 Rule Standard



FERC also sought to adapt securities precedents to the energy industry

- Market Manipulation is conduct "designed to deceive or defraud investors by controlling or artificially affecting the price of securities" (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)) or practices that "artificially affect market activity" (*Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977)), such as "attempting to influence the closing price of a stock by executing purchase or sale orders at or near the close of the market." (*Kocherhans*, No. 3-8611, 52 S.E.C. 528, 530 (1995))

*Amaranth Advisors, L.L.C.*, 120 FERC ¶ 61,085 (2007).

# Changes in Penalties



- Provide whistleblowers awards if they provide original information that leads to a successful CFTC enforcement action resulting in monetary sanctions exceeding \$1 million
- Award amount is 10% to 30% of the monetary sanctions collected
- CFTC to issue final rules and regulations implementing provisions within 270 days after enactment of the Act



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# CFTC & FERC vs Amaranth: Doing the Sister Regulator Act

SHARON BROWN-HRUSKA AND ROBERT ZWIRB

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On July 25<sup>th</sup> of this year, the Commodity Futures Trading Commission ("CFTC") announced that it was filing a civil injunctive enforcement action in the federal district court against the defunct hedge fund Amaranth Advisors and its former head trader for allegedly attempting to manipulate the price of natural gas futures contracts on the New York Mercantile Exchange ("NYMEX") in violation of the anti-manipulation provisions of the Commodity Exchange Act ("CEA"). The CFTC's complaint lays out a scheme by the defendants to depress the settlement prices of natural gas futures contracts traded on the NYMEX in order to benefit their considerably larger short positions in natural gas swaps traded on the Intercontinental Exchange ("ICE").

Seemingly lost amidst the rise and fall of Amaranth and the alleged attempt to manipulate energy prices is a jurisdictional issue of profound significance. For on the day following the CFTC's announcement, another federal regulator, the Federal Energy Regulatory Commission ("FERC"), announced that it *too* was bringing an enforcement action—albeit an administrative one—against the same defendants for the same conduct, claiming that their conduct violated the anti-manipulation provisions of the Natural Gas Act and the Federal

Power Act. Even though the alleged manipulation took place across two different markets—the futures markets and the over-the-counter financial markets—neither of which are regulated by FERC, the agency nevertheless claims that it has a jurisdictional stake in the matter on the ground that the defendants' conduct "affected" the interests of a third market—the wholesale natural gas market, which FERC does have jurisdiction over.

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## From the EDITOR

### Energy Market Manipulation

This month's edition is devoted to analyzing the anti-manipulative authority over natural gas transactions of two independent federal agencies: the Commodity Futures Trading Commission (CFTC) and the Federal Energy Regulatory Commission (FERC).

Section 2(a)(1)(A) of the Commodity Exchange Act (CEA) grants the CFTC "exclusive jurisdiction" over futures transactions, including natural gas and other energy futures, providing in pertinent part:

**The Commission shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . .**

Accounts, agreements and transactions involving futures contracts traded on designated contract markets appear to be within the CFTC's exclusive jurisdiction. With respect to such accounts, agreements, and transactions where the CFTC's jurisdiction is exclusive, other federal regulatory authorities are without jurisdiction. The jurisdiction of other federal regulatory authorities, such as FERC, appears to be limited with respect to the accounts, agreements and transactions as to which the CFTC possesses exclusive jurisdiction. But does the CEA's exclusivity provision apply to *activities* that affect the futures markets?

Now the issue of the CFTC's exclusive jurisdiction over natural gas futures trading becomes very interesting. Section 315 of the Energy Policy Act of 2005 (EPA), administered by FERC, added a new § 4A to the Natural Gas Act, which states in pertinent part:

**It shall be unlawful for any entity, directly or indirectly, to use or employ, 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, any manipulative or deceptive device or contrivance (as those terms are used in section 78j(b) of this title) in contravention of such rules and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas ratepayers.**

The EPA does not *explicitly* repeal the exclusive jurisdiction provision of the CEA. The issue is whether Congress's enactment of Section 315 of the EPA implies an intention to do so. To complicate the issue, in January 2006, FERC adopted Rule 1c.1, which states in pertinent part that:

**(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 a material fact or to omit to state a material fact necessary in order to make the statements made, in the 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.**

On July 25, 2007, CFTC brought a federal court enforcement action against Amaranth Advisors and their chief natural gas trader, alleging that they attempted to manipulate the price of March 2006 and May 2006 natural gas futures contracts traded on The New York Mercantile Exchange (NYMEX) in violation of the CEA. On July 26, 2007, FERC filed an administrative proceeding charging the same defendants with engaging in a manipulative scheme related to the settlement prices of the same NYMEX natural gas futures contracts, pursuant to FERC's new anti-manipulation statute and rule.

The CFTC, FERC and Amaranth will litigate for months to come the jurisdictional issue of whether the FERC has the authority to bring an enforcement action alleging a manipulation of an energy *futures* market. Law review articles in the future will be devoted to this topic. The readers of *FDLR* are the first to have the opportunity to become educated on this provocative issue by reading articles in this volume written by the former acting chairperson of the CFTC and leading members of the bar. Is there a *Lukken-Kelliher Jurisdictional Accord* in our future?

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***Historically, FERC was engaged in regulating the wholesale markets for natural gas and electricity, primarily as a rate making authority with limited enforcement power.***

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This assertion of jurisdiction by a second federal regulator, however, raises serious issues as to whether FERC is 1) exceeding its statutory authority under the Energy Policy Act of 2005 and whether 2) impermissibly intruding upon the “exclusive” domain of the CFTC over the futures markets. It also raises questions regarding the CFTC’s apparent acquiescence to the encroachment on its “exclusive jurisdiction” by another regulator, since the parallel actions run counter to legal precedent and efficient and effective market regulation. Further, and of greater concern, the unquestioned assertion of the FERC investigatory umbrella into yet to be determined practices and activities inherent in the conduct of financial market transactions gives rise to renewed legal uncertainty in the exchange-traded and over-the-counter derivatives markets.

## **Statutory Authority**

Historically, FERC was engaged in regulating the wholesale markets for natural gas and electricity, primarily as a rate making authority with limited enforcement power. In response to suspicions of unchecked manipulation in the energy markets in the early part of the decade, and to the FERC chairman’s call for “the same [anti-manipulation] enforcement tools” as other federal regulators,<sup>1</sup> Congress in 2005 enacted the Energy Policy Act of 2005 (“EPAAct”) to provide the agency with new enforcement tools and civil penalty authority to prevent market manipulation and market power abuse in those markets.<sup>2</sup> The law, which represents “the most significant increase in Commission regulatory authority in 70 years,”<sup>3</sup> gave FERC explicit rulemaking authority to prohibit and prevent manipulation “in connection with

the purchase or sale of natural gas . . . subject to the jurisdiction of the [FERC].”<sup>4</sup>

Although the EPAAct is aimed at market manipulation, the actual prohibition is written in traditional anti-fraud terms, prohibiting the use of any “manipulative or deceptive device or contrivance” in connection with a jurisdictional transaction, and instructs FERC to interpret those terms in the same manner as they have been used in the Exchange Act.<sup>5</sup> Given this backdrop, FERC issued new rules patterned after the SEC’s anti-fraud Rule 10b-5, though commentary at the time questioned the wisdom of applying an anti-fraud prohibition to deal with the problem of manipulation, and furthermore, of adopting a securities law standard designed to protect individual investors to govern transactions between financially sophisticated institutions in the wholesale energy commodities markets.<sup>6</sup> But FERC went ahead anyway, issuing twin rules barring “any entity” subject to FERC’s jurisdiction from engaging in fraud “in connection with” the purchase or sale of natural gas or electricity.<sup>7</sup> Moreover, in interpreting the EPAAct, FERC made clear that it views this new authority as giving it “broad jurisdiction over the entities [such as hedge funds] that engage in certain conduct *affecting* our subject matter jurisdiction.”<sup>8</sup>

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***The difficulty that FERC faces here arises from the fact that the statute is considerably narrower in scope than the broad interpretation that FERC has adopted.***

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But this argument advanced by FERC, which originates from a rulemaking context, still “does not explain why the Commission has the jurisdiction in the first place.”<sup>9</sup> One of the most revered principles of administrative law, after all, is that an agency cannot rely upon its rulemaking authority to extend the reach of its jurisdiction beyond that encompassed by statute.<sup>10</sup> The difficulty that FERC faces here arises from the fact that the

statute, which limits jurisdiction to conduct that occurs “in connection with” the purchase or sale of or natural gas, is considerably narrower in scope than the broad interpretation that FERC has adopted. FERC, therefore, should not be able to skirt around this built-in limitation by arguing that a transaction is nonetheless covered if the respondent “intended to affect, or . . . acted recklessly to affect, a jurisdictional transaction.”<sup>11</sup> For to give meaning to the jurisdictional phrase at issue, the manipulation must have occurred “in connection with” a FERC, as opposed to a CFTC-jurisdictional transaction. At least that is how it would be interpreted in the analogous securities context,<sup>12</sup> which FERC purports to be following.<sup>13</sup> To argue otherwise “would deny all meaning to the statutory phrase at issue.”<sup>14</sup>

## CFTC Exclusive Jurisdiction

Even if one assumes that FERC has sufficient authority under its statute to act here, its action nevertheless runs up against a formidable legal obstacle—the exclusive jurisdiction of the CFTC over transactions that take place on a contract market. Under Section 2(a)(1)(A) of the Commodity Exchange Act (“CEA”), the CFTC has “exclusive jurisdiction” with respect to “accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery.” Moreover, the Energy Policy Act specifically preserves this exclusive authority of the CFTC, declaring that “[n]othing . . . may be construed to limit or affect the exclusive jurisdiction of the Commodity Futures Trading Commission under the Commodity Exchange Act.”<sup>15</sup>

The exclusive jurisdiction provision was incorporated as a key aspect of the 1974 amendments to the Commodity Exchange Act (“CEA”) in order to avoid *inter alia* subjecting traders “to conflicting agency rulings.”<sup>16</sup> Prior to that time, the regulation of the commodities futures trading markets by the Commodity Exchange Authority, the CFTC’s predecessor, was shared with the Securities and Exchange Commission (“SEC”) and various state regulatory agencies. But the 1974 amendments sought to do away with this overlapping regulatory structure by “creat[ing] one federal agency with the expertise to regulate

the commodities industry.”<sup>17</sup> In passing the 1974 amendments, Congress accomplished three things of significance to the issues here. First, it centralized the regulation of the futures markets in a newly created, independent federal agency, the CFTC. Second, it endowed the CFTC with “exclusive jurisdiction” over such markets. Finally, it preempted most other state and federal regulatory authorities.

With the passage of time, it is easy to forget why Congress acted the way it did more than three decades ago in creating a comprehensive regulatory architecture for the futures industry. With continuous financial innovation brewing in the form of new futures contracts based upon mortgage interest rates and other securities, “Congress had to consider the real possibility that scores of other agencies at every level of government might attempt to regulate futures trading in the absence of preemption.”<sup>18</sup> As Russo and Lyon observed at the time,

**The fundamental congressional design was to avoid a duplicative or contradictory regulatory structure. In the 1974 amendments, Congress sought to create one federal agency with the expertise to regulate the commodities industry. In the numerous jurisdictional “gray areas,” Congress’ intent should be the touchstone in determining the scope of the CFTC’s exclusive jurisdiction.<sup>19</sup>**

While there has been considerable debate in the ensuing years over the meaning of the term “exclusive jurisdiction,” the legislative history suggests that at the very least that Congress intended the CFTC to be the “sole regulatory authority”<sup>20</sup> for the futures industry and that its authority would preempt “all other would-be regulators at every level of government.”<sup>21</sup> This view is confirmed by the Conference Reports, which state that the Commission’s exclusive jurisdiction “supersedes State as well as Federal agencies.”<sup>22</sup> And it is confirmed by most courts, which have consistently upheld the twin principles of exclusivity and preemption.<sup>23</sup>

**Prior to the 1974 amendments, the regulation of the commodities futures trading markets by the CFTC's predecessor was shared with the SEC and various state regulatory agencies.**

To be sure, much of the precedent in this area springs from the resistance of one federal agency, the Securities and Exchange Commission (SEC), that has “never really accepted” the notion of CFTC exclusive jurisdiction.<sup>24</sup> But the SEC’s parochial vision, which has led it at times to go to court to seek jurisdiction over various forms of futures instruments including so-called London options, mortgage-backed futures, and index participations, has met with little success with most courts viewing the 1974 amendments as “serv[ing] to strip the SEC of standing to bring [such] suit[s].”<sup>25</sup> Indeed, one court has characterized the dispute between the SEC and the CFTC as “a zero-sum game because of the exclusivity clauses in the CEA.”<sup>26</sup> Under this view, as Judge Frank Easterbrook frames it, jurisdiction is tied to the nature of the underlying financial instrument:

**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.**<sup>27</sup>

No doubt the historical preoccupation with the jurisdictional ambitions of one federal agency in particular was well founded. Indeed, much of the legislative history of the 1974 amendments relates to efforts to carve out appropriate regulatory space for that agency. But while the focus was on the SEC and its efforts to thwart the development of financial futures, the decision to vest the CFTC with exclusive jurisdiction was designed to address “a far broader problem.”<sup>28</sup> As former CFTC Chairman Philip Johnson observed: “Congress had to consider the real possibility that scores of other agencies at every level of government might attempt to regulate futures trading in the absence

of preemption.”<sup>29</sup> Ironically, the possible intrusion of regulatory authorities in the energy area was foreseen to pose a threat to the new regulatory vision. As Chairman Johnson summed up the threat at the time: “The possibility of futures trading in petroleum also was known to Congress. Potential regulators of that contract could range from the Federal Energy Administration to the state agencies controlling crude oil production.”<sup>30</sup>

The problem that FERC encounters in attempting to get around this jurisdictional wall is that while the preemptive effect of the CEA is not absolute, *e.g.*, it does not apply to activities that lie outside the scope of § 2(a)(1)(A),<sup>31</sup> Amaranth’s conduct is directly related to the “actual sale of commodity futures,” that unquestionably comes within the sphere of the exclusivity provision. In other words, this is not a case where the activities at issue lie within the primary, but *non-exclusive* jurisdiction authority of the CFTC, as for example if it had involved the marketing activities of Amaranth. In that instance, another regulator arguably would be allowed to proceed.<sup>32</sup> But the alleged misconduct at issue here clearly involves activities related to “the buying and selling of futures,” something that goes to the heart of the exclusive jurisdiction clause and something that presumably would preclude action by another federal regulator.<sup>33</sup>

FERC nevertheless maintains that it can assert jurisdiction over such trading when it “affect[s] our jurisdictional markets.”<sup>34</sup> But that very argument was rejected by the United States Supreme Court in *Northwest Central Pipeline v. State Corporation. Commission* in the context of state preemption, which cautioned FERC against extravagantly interpreting its powers over transportation and rates of natural gas to include those areas clearly “reserved to the States.”<sup>35</sup> One would think that the same principle would apply equally to those areas expressly reserved to the CFTC.

## FERC & CFTC “Acting in Concert”

In furtherance of its “affects” argument, FERC propounds the notion that “where the [energy] markets are interconnected, both agencies have jurisdiction to prohibit market manipulation.”<sup>36</sup> But other than alluding to the “overlapping” and

“complementary” nature of the agencies’ regulatory mandates and to a Memorandum of Understanding (MOU) that they entered into to better “coordinate” their activities, FERC provides little support to underlie its claim.<sup>37</sup> Nor does the statement of that agency’s chairman—that the two agencies are “acting in concert”—provide a compelling rationale.<sup>38</sup> For it is unclear how such interconnectivity between the markets or for that matter, how such close cooperation between two agencies serves as a basis of jurisdiction for one agency when jurisdiction is expressly reserved for the other. Nor can a MOU alter this carefully divided jurisdictional landscape, and even if it somehow could, agencies simply cannot alter their jurisdiction “by mutual agreement.”<sup>39</sup>

To be sure, there is a rich history of concurrent enforcement activity by the two agencies that began well before the enactment of the Energy Policy Act of 2005.<sup>40</sup> Moreover, they have not hesitated in recent times to file separate actions for the same conduct against the same respondents.<sup>41</sup> In addition, FERC cites to the *Reliant Energy* matter<sup>42</sup> and the SEC’s case in *Hopper*<sup>43</sup> as examples of where the courts permitted a second agency to pursue charges of manipulation without intruding upon the CFTC’s anti-manipulation jurisdiction. But in neither case nor in any of the others where the two agencies acted did the manipulation take place in the futures market. Instead, it occurred in either the physical cash or OTC financial markets, which under certain circumstances are subject to the CFTC’s *non-exclusive* jurisdiction. By contrast, the unique aspect of the Amaranth case is that the alleged manipulation took place on a contract market that is subject to the CFTC’s exclusive jurisdiction.

Moreover, from the beginning of its creation, the CFTC has repeatedly been called upon to defend its turf and the young agency never shirked its duty. As previously discussed, not long after the passage of the 1974 amendments, it was judicially recognized that “Congress intended no regulation in this field except under the authority of the Act.”<sup>44</sup> But the expansive scope of the CEA’s exclusive jurisdiction provision coupled with the broad definition of the term “commodity” that

was also adopted in 1974 nevertheless made it inevitable that jurisdictional conflicts would arise.

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***The unique aspect of the Amaranth case is that the alleged manipulation took place on a contract market that is subject to the CFTC’s exclusive jurisdiction.***

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Thus, in 1975, in response to the contention of SEC Chairman Roderick M. Hills that the federal securities laws should govern futures on mortgage-backed certificates guaranteed by the Government National Mortgage Association, the CFTC explained to Mr. Hills that “it is unwilling to concede the right of any other enforcement agency to do the job that Congress has expressly entrusted to the CFTC alone.”<sup>45</sup> Likewise, when it was suggested that California could impose more stringent requirements upon commodity trading advisers than the CFTC’s on the ground such an imposition would not be “contrary” to any CFTC requirement, the agency threw cold water on that argument, noting that “it would be inconsistent with the overriding Congressional desire to establish uniform national regulation in this area to allow supplementary regulation by states.”<sup>46</sup> And when the challenge took place in the courts, the CFTC typically made its views known as it did when the SEC sought to regulate a type of futures contract called an index participation. *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537 (7<sup>th</sup> Cir. 1989). Even today, the CFTC is battling the SEC in court over whose interest should prevail in the collapse of an investment management company that served the futures industry.<sup>47</sup> As former Chairman Johnson noted, “[t]he CFTC, to its credit, has expressed its determination to resist all efforts to erode its exclusive jurisdiction.”<sup>48</sup>

In contrast to its combative relationship with the SEC, the CFTC’s relationship with FERC is much more conciliatory, with the two agencies emphasizing the great degree of cooperation, coordinating their investigations closely, and even allowing their enforcement directors to appear together at various legal forums to announce their

joint activities. At these joint appearances, the agencies appear to be singing from the same tune, “We are family, I got all my sister regulators with me.”<sup>49</sup> Indeed, FERC Chairman Kelliher has acknowledged that the well-coordinated announcements of two federal enforcement actions against Amaranth were “completely deliberate,”<sup>50</sup> and stressed that the CFTC did not raise any concerns during the months that two agencies jointly investigated Amaranth.<sup>51</sup> But if the two agencies are relying upon their mutual endorsement to expand their respective authority, experience suggests it will not work. For as the Seventh Circuit cautioned in *Board of Trade of the City of Chicago*: “we cannot allow the CFTC and [another federal agency] to reapportion their jurisdictions in the face of a clear, contrary statutory mandate.”<sup>52</sup>

## Conclusion

Amid the bravado that accompanied the CFTC and FERC’s press releases and that typically accompanies the government’s announcement of such solemn actions nowadays, *e.g.*, “rest assured . . . illegal conduct will be uncovered and prosecuted,”<sup>53</sup> there seems little consideration of the long term cost and the unintended consequences of the FERC’s encroachment on the CFTC’s exclusive jurisdiction. For in addition to the announcement’s pledges of “ongoing vigilance” and “unwavering determination” to ensure market integrity,<sup>54</sup> the CFTC must also be vigilant about defending the integrity of its own jurisdiction.

Without question, it is in the interest of regulatory authorities to share information and cooperate to ensure market integrity and adequate coverage of interrelated sectors of business activity.<sup>55</sup> But market integrity is more than just a convenient term for the roll out of the latest enforcement action. Ultimately, market integrity is also dependent upon clear and consistent regulatory principles and the application of rules and laws for the furtherance of legitimate commercial enterprise, the assumption of risk, and the pursuit of innovation. The existence of multiple standards, liberally and variously interpreted to govern the same conduct in the same market, does not create conditions that are conducive to these outcomes, but rather paves a path to increasing the costs of

business activity, as market participants, intermediaries, and markets within that sector must adapt to contend with competing authorities.

In fact, the original intent for initiating the negotiation of a memorandum of understanding, which was ongoing and preceded the passage of the EAct, was to avoid duplication and cross-purpose efforts in regulatory and enforcement activities, ensure the protection of proprietary information as envisioned in Section 8 of the CEA, and to clarify and affirm the CFTC’s exclusive jurisdiction. With the benign acquiescence of the CFTC following the passage of the EAct, the MOU that was penned ultimately enabled FERC to apply an inverse logic to support a narrow view of the CFTC exclusive jurisdiction, and to justify its replication of surveillance and enforcement activities of the CFTC in the futures markets.<sup>56</sup> Only after Amaranth filed a motion for a stay of the FERC’s administrative proceeding in federal district court did the CFTC assert its jurisdiction, and it did so in response to the court’s request that it address this issue.<sup>57</sup>

In addition to interpreting CFTC cooperative gestures as an invitation to bring a redundant action for the same conduct, FERC has also applied a forewarning posture to support an expression of interest into unspecified conduct of regulated entities positioned within the CFTC jurisdiction.<sup>58</sup> Given the intent of Congress in the original Commodity Exchange Act, and later, the Commodity Futures Modernization Act to apply an appropriate regulatory scheme to these markets, and provide an avenue to the CFTC to determine the scope of that authority through its enforcement and interpretations, FERC’s understanding of its jurisdiction represents a wild card for futures commission merchants, brokers, hedge funds, banks and other financial institutions that provide liquidity and capital to the energy markets.

Moreover, FERC’s assertion of authority into financial market activities that are outside the realm of wholesale natural gas transactions could carry it even farther, beyond the province of the exclusive territory of the CFTC into the non-exclusive jurisdiction of the agency, as well. FERC’s broad interpretation of the Natural Gas Act to include anything that may affect wholesale trans-

actions is tailor made for application to other derivative and financial markets. The arguments made to support the jurisdictional case in *Amaranth*, apart from the sister act that accompanied it, would extend equally well to those markets exempt from direct CFTC regulation that nonetheless are subject to the CFTC's anti-fraud and anti-manipulation authority.

In sum, FERC's broad and expansive view of its jurisdiction creates regulatory and legal uncertainty that imposes additional burdens and costs on market participants, exchanges, financial intermediaries, and ultimately could harm their willingness to assume risks and to innovate new products and markets. As the John Gaine, President of the Managed Funds Association, observes: "Multiple regulators sharing concurrent jurisdiction will not strengthen regulation, it will just water down regulation at a considerable cost to market participants."<sup>59</sup>

It shall be unlawful for any entity, directly, or indirectly, to use or employ, in connection with the purchase or sale of or natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance (as those terms are used in section 10 of the Securities Exchange Act of 1934) . . . in contravention of such rules and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas [or electric] ratepayers.

EPAAct 2005, § 315, 15 U.S.C. § 717 c-1.

5. 15 U.S.C. § 717 c-1 (2007).
6. See e.g., Comments of the International Swaps and Derivatives Association, Inc., Docket No. RM0-3, at 4-5 (Nov. 17, 2005). Indeed, courts generally do not favor such wholesale attempts to transplant foreign legal doctrines to govern other legal proceedings, especially in the administrative context. See, e.g., *Elliott v. Commodity Futures Trading Com'n*, 202 F.3d 926, 936, Comm. Fut. L. Rep. (CCH) P 28000 (7<sup>th</sup> Cir. 2000) (holding that doctrines that bind courts in other legal areas cannot "be transposed unmodified to guide the regulation of the commodity exchanges").
7. The new rules, entitled "Prohibition of Energy Market Manipulation," were also issued in twin versions to correspond with transactions conducted pursuant to the Federal Power Act and Natural Gas Act. The rule pertaining to natural gas reads as follows:
  - (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 a material fact or to omit to state a material fact necessary in order to make the statements made, in the 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

#### NOTES

1. See Joseph T. Kelliher, *Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission*, 26 Energy L. J. 1, 30 (2005) (noting that FERC lacked "necessary tools" to deal with the threat of market manipulation and arguing "[t]here is no valid public policy reason why the Commission should not have the same enforcement tools as other federal economic regulatory agencies.>").
2. Pub.L. No. 109-58, 119 Stat. 594 (2005),
3. Chairman Joseph T. Kelliher, Letter to Congress, Federal Energy Regulatory Commission, Annual Report 2006 at 3 (Apr. 26, 2007), available at <http://ferc.gov/about/strat-docs/fy06-an-rpt.pdf>.
4. The relevant statutory language, which was issued in separate but virtually identical versions to correspond to relevant provisions in the Federal Power Act and Natural Gas Act, reads as follows:

- would operate as a fraud or deceit upon any entity.
- 18 C.F.R. §1c.1, issued in Order No. 670, 114 F.E.R.C. 61,047 (Jan. 19, 2006).
8. Federal Energy Regulatory Commission, *Prohibition of Energy Market Manipulation, Final Rule*, 71 Fed. Reg. 4244, 4248 (Jan. 26, 2006)(emphasis added).
  9. *Conoco Inc. v. F.E.R.C.*, 90 F.3d 536, 553 (D.C. Cir. 1996).
  10. *Ernst & Ernst v. Hochfelder*, 452 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668, Fed. Sec. L. Rep. (CCH) P 95479 (1976) (scope of Rule 10b-5 cannot exceed power granted SEC under § 10(b) of the Exchange Act).
  11. *Prohibition of Energy Market Manipulation, Final Rule*, 71 Fed. Reg. at 4249.
  12. See *S.E.C. v. Zandford*, 535 U.S. 813, 820, 122 S. Ct. 1899, 153 L. Ed. 2d 1, Fed. Sec. L. Rep. (CCH) P 91795 (2002); *Wharf (Holdings) Ltd. v. United Intern. Holdings, Inc.*, 532 U.S. 588, 121 S. Ct. 1776, 149 L. Ed. 2d 845, Fed. Sec. L. Rep. (CCH) P 91425, 44 U.C.C. Rep. Serv. 2d 569 (2001); *Leykin v. AT & T Corp.*, 423 F.Supp. 2d 229, 241 (S.D. N.Y. 2006), judgment aff'd, 216 Fed. Appx. 14, Fed. Sec. L. Rep. (CCH) P 94149 (2d Cir. 2007) ("Not all conduct that negatively affects a company's stock price is actionable as a federal securities fraud. The scheme to defraud must coincide with the sale of securities.>").
  13. See, e.g., *Energy Markets: Chairman Kelliher discusses Amaranth, Energy Transfer Partners market manipulation cases* (July 31, 2007), available at <http://www.ferc.gov/news/headlines.asp>. ("Kelliher Interview"): "We think the law is clear, based upon securities precedent. The law that we're overseeing, at least with respect to Amaranth, is securities law lifted out of the Securities Exchange Act 1934, put in both the Natural Gas Act and the Federal Power Act. So there is precedent in this area of manipulating one kind of product to benefit a position in another product. And we do have legal authority."
  14. *Commodity Futures Trading Com'n v. P.I.E., Inc.*, 853 F.2d 721, 727 (9th Cir. 1988) (Kozinski J. dissenting) (discussing the CEA clause "on or subject to rules of any contract market"). See also, *Richmond Power and Light of City of Richmond, Ind. v. Federal Energy Regulatory Commission*, 574 F.2d 610, 620, 24 Pub. Util. Rep. 4th (PUR) 609 (D.C. Cir. 1978) ("What the Commission is prohibited from doing directly it may not achieve by indirection.>").
  15. 15 U.S.C. § 717 t-2(c)(2) (2007).
  16. 120 Cong. Rec. S 16,127, 16128 (daily ed. Sep. 9, 1974) (statement of chairman Herman Talmadge, Senate Committee on Agriculture).
  17. Thomas A Russo and Edwin L. Lyon, *The Exclusive Jurisdiction of the Commodity Futures Trading Commission*, 6 Hofstra L. Rev. 57, 90 (1977).
  18. Philip F. Johnson, *The Commodity Futures Trading Commission Act: Preemption as Public Policy*, 29 Vand. L. Rev. 1, 25 (1960) (quoting the Chairman of the Chicago Board of Trade).
  19. Russo & Lyon, 6 Hofstra L. Rev. at 90.
  20. Johnson, at 18.
  21. *Id.* at 2.
  22. S. Rep. No. 1194, 93d Cong., 2d Sess. 35 (1974); H.R. Rep. No. 1383, 93d Cong., 2d Sess. 35, reprinted in 1974 U.S. Code Cong. & Ad. News 5894, 5897.
  23. See e.g., *State v. Monex International, Limited*, 527 S.W.2d 804, Blue Sky L. Rep. (CCH) P 71234 (Tex. Civ. App. Eastland 1975), writ refused, (Dec. 17, 1975), (disallowing action by Texas to enjoin Monex from selling leverage contracts which had not been registered under the state securities laws on ground that newly established CFTC "now has exclusive jurisdiction to regulate [Monex's] margin account sales"); *Clayton Brokerage Co. of St. Louis, Inc. v. Mouer*, 531 S.W.2d 805, Blue Sky L. Rep. (CCH) P 71273 (Tex. 1975) (dismissing as moot, state suit against brokerage company dealing in London commodity options on ground that CFTC's jurisdiction to regulate such options was exclusive); *International Trading Ltd. v. Bell*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,495 at 21,996 (Ark. Oct 3, 1977) (holding that "[w]here . . . Congress has made it clear that authority conferred by it is exclusive in a given area, the states cannot exercise concomitant or supplementary regulatory authority over the identical activity.>").
  24. *Board of Trade of the City of Chicago v. S.E.C.*, 677 F.2d 1137, 1150, Fed. Sec. L. Rep. (CCH) P 98605 (7th Cir. 1982), cert. granted, judgment vacated, 459 U.S. 1026, 103 S. Ct. 434, 74 L. Ed. 2d 594 (1982) and cert. granted, judgment vacated, 459 U.S. 1026, 103 S. Ct. 434, 74 L. Ed. 2d 594 (1982) (quoting Bromberg, *Securities Law-Relationship to Commodities Law*, 35 Bus. Law. 787, 791 (1980).) Indeed, it goes beyond that given the ceaseless attempts by the SEC to take over the CFTC.
  25. *Securities and Exchange Commission v. Univest, Inc.*, 405 F.Supp. 1057, 1059, Fed. Sec. L. Rep. (CCH) P 95369 (N.D. Ill. 1975) (holding that CEA's exclusive jurisdiction provision "serves to strip

- the SEC of standing to bring" suit against seller of London options on commodities for future delivery). See also, *Board of Trade of the City of Chicago v. S.E.C.*, 677 F.2d at 1150 (exclusivity provision deprives SEC of jurisdiction to regulate trading in options on GNMA mortgage-backed pass-through certificates).
26. *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537, 547, Fed. Sec. L. Rep. (CCH) P 94559, Fed. Sec. L. Rep. (CCH) P 94795 (7<sup>th</sup> Cir. 1989).
  27. *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d at 548.
  28. Johnson, at 25.
  29. *Id.*
  30. *Id.*
  31. *F.T.C. v. Ken Roberts Co.*, 276 F.3d 583, 591, 2002-1 Trade Cas. (CCH) P 73536, Comm. Fut. L. Rep. (CCH) P 28696 (D.C. Cir. 2001) (CEA exclusivity provision does not apply to marketing of investor-education courses that leads only tangentially to actual purchase of futures). The exclusivity provision also does not apply to State actions brought under general antifraud statutes or even the anti-fraud provisions of the CEA. See CEA Sec. 6d (expressly permitting State authorities to proceed against off-exchange commodities-related wrongdoing and to initiate anti-fraud proceedings in State court).
  32. *F.T.C. v. Ken Roberts Co.*, 276 F.3d at 591 (CEA does not preclude Federal Trade Commission from investigating deceptive marketing practices by firm marketing instruction on futures trading).
  33. *F.T.C. v. Ken Roberts Co.*, 276 F.3d at 590 (CEA's exclusive jurisdiction provision does not apply to practices of firms that sell not futures themselves, but rather instruction on futures trading).
  34. Federal Energy Regulatory Commission, Order to Show Cause and Notice of Proposed Penalties ("Show Cause Order") at 26. Moreover, it is ironic that FERC cites the "effect" that activity that occurs on another market as justification for asserting its authority since the EAct expressly prohibits FERC from construing its authority so as to limit "or affect" the CFTC's exclusive jurisdiction.
  35. *Northwest Central Pipeline Corp. v. State Corp. Comm'n of Kansas*, 489 U.S. 493, 514, 109 S. Ct. 1262, 103 L. Ed. 2d 509, 100 Pub. Util. Rep. 4th (PUR) 1 (1989) ("To find field of pre-emption of Kansas' regulation merely because purchaser's costs and hence rates might be affected would be largely to nullify that part of NGA § 1(b) that leaves to the States control over production, for there can be little if any regulation of production that might not have at least an incremental effect on the costs of purchasers in some market and contractual situations.") (emphasis added).
  36. Show Cause Order at 27.
  37. *Id.* at 26.
  38. Kelliher Interview. Chairman Kelliher's remarks regarding jurisdiction were as follows:  
  
They are acting in concert with us. What we're doing is we're acting to sanction manipulation of futures that affected FERC jurisdictional transactions. Natural gas is a fungible commodity. It's interchangeable, but it's sold in, as many different products. There are really three broad product categories; physical wholesale gas, where FERC has jurisdiction, there's financial products, and there's also futures products. And those are areas of CFTC jurisdiction. You can clearly see manipulation of one kind of natural gas product in order to affect a profit somewhere else. Now, if someone seeking to manipulate natural gas markets can move across product lines confident that the two agencies will never work in concert, then that's a huge opportunity for manipulation. We [and the] CFTC want to block that. We think the law is clear, based on securities precedent.
  39. *Chicago Mercantile Exchange v. S E C*, 883 F.2d at 544. See also *Board of Trade of the City of Chicago v. S E C*, 677 F.2d at 1142 n.8 (noting that while SEC and CFTC may "maintain communications" and otherwise "cooperate" regarding CFTC activities that "relate" to SEC responsibilities, "the two agencies cannot thereby enlarge or relinquish their statutory jurisdictions").
  40. See also Paul J. Pantano, Jr. and Kari S. Larsen, *Concurrent Investigations by the CFTC and the FERC into Alleged Power and Natural Gas Price Manipulation: Who's on First? Futures & Derivatives Law Report* (Jan 2003).
  41. See Allan Horwich, *Warnings to the Unwary: Multi-Jurisdictional Federal Enforcement of manipulation and Deception in the Energy Markets After the Energy Policy Act of 2005*, 27 Energy L. J. 363, 393-394 (2006) (observing that the CFTC and FERC negotiated settlements for the same conduct against energy firms

- American Electric Power Company and Coral Energy Resources, L.P.).
42. *U. S. v. Reliant Energy Services, Inc.*, 420 F. Supp.2d 1043 (N.D. Cal. 2006). Moreover, *Reliant* was a criminal prosecution that did not implicate the exclusivity provision of the CEA.
  43. *S.E.C. v. Hopper*, Fed. Sec. L. Rep. (CCH) P 93878, 2006 WL 778640 (S.D. Tex. 2006).
  44. *International Trading Ltd. v. Bell*, 262 Ark. 244, 556 S.W. 2d 420, 423-24, Blue Sky L. Rep. (CCH) P 71393 (1977) (vesting of exclusive jurisdiction with the CFTC “supersede[s] the jurisdiction of all state and federal agencies”).
  45. Memorandum of the Office of the General Counsel of the Commodity Futures Trading Commission Concerning the Exclusive Jurisdiction of the Commission over Futures Transactions, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,117, at 20,840 (Dec. 3, 1975).
  46. CFTC Interpretive Letter No. 76-20, [Preemption of State Authority to Regulate Trading Advisors], [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,214, at 21,162 (Sep 29, 1975).
  47. Jeremy Grant, *Lack of Consensus Dogs US Regulators*, Financial Times, Aug. 27, 2007 (describing the conflicting agendas of the SEC and CFTC in resolving the collapse of Sentinel Management).
  48. Johnson, at 43.
  49. With apologies to the musical group Sister Sledge, *We Are Family* (Rhino Records 1979).
  50. *Big Week at FERC, CFTC*, Scudder Publishing Group (Aug. 2007). As Chairman Kelliher elaborated:
 

It was completely deliberate. It was intended to make plain that FERC and the CFTC do coordinate their enforcement actions and that there is no conflict between the agencies. In a lot of (our) investigations, there is seamless cooperation between the two agencies. We think this is important.
  51. Tom Dogget, FERC Defends Role To Fight Natgas Mkt Manipulation, Reuters (Sept. 20, 2007).
  52. Board of Trade of the City of Chicago v. S.E.C., 677 F.2d at 1142.
  53. Gregory Mocek, Director, Div. of Enforcement, CFTC, *A Market Watchdog That’s Doing Its Job*, Wash. Post, A-12 (Letter to the Editor, Aug. 14, 2007).
  54. CFTC Enforcement Press Release No. 5359-07 (July 25, 2007).
  55. The CFTC and the FERC have cooperated on numerous occasions, sharing information and expertise in the energy markets to help resolve challenges in credit risk, market transparency, and liquidity that plagued the non-futures energy markets in the post-Enron environment. Early and frequent cooperation on enforcement actions is essential to ensure that authorities (including the Department of Justice, States Attorneys, CFTC, FERC, etc.) do not inadvertently compromise the discovery or investigatory process or prematurely reveal findings before their sister law enforcers have time to proceed.
  56. That narrow view of the CFTC’s jurisdiction is amply evident in the Amaranth filing, in which FERC proclaims that it does “not have jurisdiction to *directly* [emphasis added] regulate trading” and that CFTC’s “exclusive jurisdiction is not to be read to interfere with separate jurisdiction granted to other federal agencies”. Show Cause Order at 26 & n.73. FERC’s citation of CEA, 7 U.S.C. 2(a)(1)(A) to suggest that the CFTC is statutorily constrained not to interfere with FERC’s action, however, is an inversion of the statute’s plain language, *i.e.*, that CFTC should not seek to bring actions in a fellow regulator’s purview.
  57. See Plaintiff’s Memorandum of Law in Opposition to Defendants’ Motion for a Preliminary Injunction Staying the Federal Energy Regulatory Commission, Commodity Futures Trading Commission v. Amaranth Advisors LLC, Case No. 07 Civ. 6682 (DC)(Sep. 28, 2007).
  58. For example, in remarks delivered to a forum of energy lawyers, Susan Court, FERC’s Director of Enforcement stated that from her perspective, an entity not otherwise regulated by FERC would nevertheless come within its jurisdiction even if its activity related to a non-jurisdictional transaction so long as it *affected* a jurisdictional transaction (such as the sale of natural gas). Remarks of Susan Court at *CFTC and FERC: Coordinating Enforcement* (Futures Industry Association Luncheon, New York, May 24, 2007).
  59. John G. Gaine, President, Managed Funds Association, Prepared Statement of Managed Funds Association Before The Commodity Futures Trading Commission On Oversight of Energy Markets, at 4 (September 18, 2007).

# Is the FERC's Anti-Manipulation Jurisdiction Boundless?

BY PAUL J. PANTANO, JR. AND DANIELLE K. SCHONBACK

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## I. Introduction

Prior to January 2006, the Federal Energy Regulatory Commission (the "FERC") relied upon Market Behavior Rule 2 which was incorporated into sellers' market-based rate tariffs and rate schedules, and its parallel natural gas rule to police manipulation of the prices of wholesale energy transactions subject to the FERC's jurisdiction.<sup>1</sup> Market Behavior Rule 2 and its corollary natural gas rule prohibited conduct that "foreseeably could manipulate market prices, market conditions, or market rules . . ."<sup>2</sup> These rule have been supplanted by the FERC's final rule on the *Prohibition of Energy Market Manipulation*.<sup>3</sup>

The Energy Policy Act of 2005 ("EPAct") prohibits the use or employment of manipulative or deceptive devices or contrivances in connection with the purchase or sale of natural gas, electric energy, natural gas transportation or electricity transmission services under the jurisdiction of the FERC.<sup>4</sup> This language is modeled on Section 10(b) of the Securities Exchange Act of 1934.<sup>5</sup> The FERC promulgated an Anti-Manipulation Rule under new section 222 of the Federal Power Act ("FPA") and new section 4a of the Natural Gas Act ("NGA") prohibiting the employment of manipulative or deceptive devices or contrivances.<sup>6</sup> When it adopted the Anti-Manipulation

Rule, the FERC explained that an entity violates the Anti-Manipulation Rule when it: "(1) . . . engages in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) with the requisite scienter; (3) *in connection with* the purchase or sale of natural gas . . . subject to the jurisdiction of the Commission."<sup>7</sup>

The Anti-Manipulation Rule applies only in the context of an enforcement action brought by the FERC.<sup>8</sup> It states expressly that it does not create a right of action for private parties.<sup>9</sup> The FERC announced in the preamble to the Anti-Manipulation Rule that it intends to determine on a case-by-case basis when it will apply Rule 10b-5 case law precedent to conduct involving or affecting wholesale energy transactions.<sup>10</sup>

On July 26, 2007, the FERC for the first time used its new enforcement authority to prosecute market manipulation by initiating two administrative show cause proceedings under the new Anti-Manipulation Rule against Amaranth<sup>11</sup> and its former market manipulation rule, Market Behavior Rule 2, against ETP.<sup>12</sup> The Amaranth Show Cause Order, in particular, has created considerable controversy over whether the FERC's anti-manipulation jurisdiction extends to the trading of futures contracts that arguably affects the prices of the FERC's jurisdictional transactions.<sup>13</sup> In a letter to the Commodity Futures Trading Commission (the "CFTC") Acting Chairman, Walter Lukken, U.S. Senators Dianne Feinstein, Maria Cantwell, and Ron Wyden urged the CFTC to work in tandem with the FERC to pursue cases of manipulation in energy markets and "not become entangled in a turf battle."<sup>14</sup> The warnings come as Congress considers giving regulators broader market oversight responsibilities in both regulated and unregulated markets such as electronic trading platforms.<sup>15</sup> In addition, Senator Norm Coleman, the Senate's Permanent Subcommittee on Investigations' ranking member, asked the Senate Agriculture, Nutrition and Forestry Committee to schedule hearings on, and a markup of, the reauthorization of the Commodity Exchange Act, which has not been changed since 2000.<sup>16</sup> Senator Coleman voiced his concern that "incomplete information and inadequate authority make it

difficult, if not impossible, for the commission to effectively monitor and prevent excessive speculation and price manipulation in our energy markets.”<sup>17</sup>

This article analyzes the possible implications of applying U.S. Securities and Exchange Commission (“SEC”) precedent to the FERC’s anti-manipulation proceedings and the FERC’s nearly boundless jurisdiction in light of its recent orders to show cause against ETP and Amaranth.<sup>18</sup> In an effort to create parameters and provide guidance to market participants subject to the FERC’s jurisdiction, we suggest that the FERC should apply reasonable self-limiting principles to the exercise of its jurisdiction under the Anti-Manipulation Rule.

## II. Broad Interpretation of Jurisdiction

The FERC takes a very broad — arguably limitless — view of its jurisdiction under the Anti-Manipulation Rule. When the FERC issued the Anti-Manipulation Rule, Chairman Kelleher announced that modeling it closely on Section 10(b) and Rule 10b-5 should provide benefits to regulated entities, since there is a substantial body of precedent applying the comparable language in the 1934 Act.<sup>19</sup> The practical problem with Chairman Kelliher’s observation is that precedent interpreting the SEC’s jurisdiction under Section 10(b) and Rule 10b-5 has limited relevance to the scope of the FERC’s jurisdiction because the relationship between the parties to securities transactions differs from the relationship between the parties to the FERC-jurisdictional transactions.<sup>20</sup> The SEC, in enforcing Rule 10b-5, has interpreted the statute and rule broadly to cover brokers who sell securities on behalf of their customers with the intent to misappropriate the proceeds. Courts have given deference to the SEC’s interpretation and found that Congress drafted the statute with the intent that it be applied broadly. By adopting almost verbatim the text of Rule 10b-5 as the FERC’s Anti-Manipulation Rule that applies to the FERC-jurisdictional electricity and natural gas transactions, the FERC has positioned itself

to rely on the SEC precedent and its broad application.

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***The Supreme Court has adopted a broad interpretation of the scope of the phrase “in connection with” in Rule 10b-5, but has explicitly required that the fraud must be coincident to the sale of securities.***

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The use of fraudulent and deceptive practices to manipulate wholesale energy prices contravenes the FERC’s statutory responsibility to ensure that the prices for FERC-jurisdictional transactions are “just and reasonable.”<sup>21</sup> However, the “in connection with” language in the FERC Anti-Manipulation Rule has the potential to enable the FERC to challenge conduct that has only a tenuous, if any, tie to what the FPA and NGA delineate as the FERC-jurisdictional transactions.<sup>22</sup> The Supreme Court has adopted a broad interpretation of the scope of the phrase “in connection with” in Rule 10b-5, but has explicitly required that the fraud must be coincident to the sale of securities.<sup>23</sup> Under current securities precedent, it is often enough that the fraud alleged “coincide” with a securities transaction — whether by the plaintiff or by someone else.<sup>24</sup> The requisite showing is “deception ‘in connection with the purchase or sale of any security,’ not deception of an identifiable purchaser or seller.”<sup>25</sup> The Supreme Court’s broad interpretation of Rule 10b-5 comports with the longstanding views of the SEC.<sup>26</sup>

When analyzing the phrase “in connection with” in other statutes, the courts have consistently relied on Congress’ broad interpretation of that phrase under Rule 10b-5. For instance, in *Sofonia v. Principal Life Insurance Co.*, the United States Court of Appeals for the Eighth Circuit construed the phrase “in connection with the purchase or sale of a covered security” as used in the Securities Litigation Uniform Standards Act,<sup>27</sup> by looking to interpretations of identical language used in Section 10(b) and Rule

10b-5.<sup>28</sup> As used in Section 10(b) and Rule 10b-5, the courts construe the phrase “in connection with the purchase or sale of a covered security” not technically and restrictively, but flexibly.<sup>29</sup> Likewise, in *Merrill Lynch v. Dabit*, the Supreme Court analyzed the phrase “in connection with” in the SLUSA and relied upon the longstanding precedent derived from Rule 10b-5 case law.<sup>30</sup> The Court emphasized that “Congress can hardly have been unaware of the broad construction adopted by both this Court and the SEC when it imported the key phrase ‘in connection with the purchase or sale’ into SLUSA’s core provision.”<sup>31</sup> The Supreme Court reasoned that when “judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well.”<sup>32</sup>

However, some courts have rejected the FERC’s broad view that the “in connection with” standard that allows it to sue a party whose conduct allegedly affected a FERC-jurisdictional transaction even when that party has not engaged in a FERC-jurisdictional transaction.<sup>33</sup> For example, in *Ontario Public Service Employees v. Nortel Networks Corp.*, the U.S. Court of Appeals for the Second Circuit dismissed a complaint under Section 10(b) and Rule 10b-5 because the plaintiffs, who were not purchasers or sellers of the alleged manipulator’s stock, lacked standing to sue.<sup>34</sup> The court rejected the arguments that the anti-manipulation provisions of Section 10(b) cover purchases and sales of “any” securities and that the statute was intended to be construed “flexibly” to achieve this result.<sup>35</sup> Instead, the court held that the alleged misrepresentation by one company that merely “affected” the price of another company’s securities was insufficient to give the plaintiffs standing to sue under Section 10(b) or Rule 10b-5.<sup>36</sup>

### III. FERC’s Show Cause Orders

On July 26, 2007, the FERC issued two administrative orders to show cause that made preliminary findings of market manipulation and proposed civil penalties totaling \$458 million in two matters involving traders’ unlawful actions

in natural gas markets.<sup>37</sup> The FERC’s show cause orders mark the first prosecution of market manipulation by the FERC since Congress gave the FERC new enforcement powers two years ago. In addition, the show cause orders represent the first time the FERC has proposed maximum civil penalties.

According to the Amaranth Show Cause Order, Amaranth’s manipulation of the Natural Gas (“NG”) Futures Contract settlement price was “in connection with” FERC-jurisdictional transactions.<sup>38</sup> The FERC reasoned that the effect of any manipulation of the NG Futures Contract settlement price on the FERC-jurisdictional transactions is self-executing because the parties to wholesale NG transactions selected the NG Futures Contract settlement price in advance as a price benchmark and as a basis of the bargain.<sup>39</sup> Relying on the courts’ liberal construction of Rule 10b-5, the FERC concluded that the Anti-Manipulation Rule applies where there is a “nexus” between the manipulative conduct and the jurisdictional transaction.<sup>40</sup> In addition, the FERC reiterated its position that a determination of manipulation, in general, is “a question of fact that is to be determined by all the circumstances of a case.”<sup>41</sup> Based upon the facts described in the Amaranth Show Cause Order, the FERC concluded that the manipulative conduct on a listed derivatives market over which the CFTC has exclusive jurisdiction met the generalized “in connection with” requirement in FERC’s Anti-Manipulation Rule.<sup>42</sup>

Even though the ETP Show Cause Order relies on former Market Behavior Rule 2 because the conduct occurred prior to January 2006, the FERC applied the same jurisdictional principles that it relied on in the Amaranth Show Cause Order. In the ETP Show Cause Order, the FERC directed ETP to show cause why the FERC should not find that ETP manipulated physical gas markets from December 2003 through December 2005.<sup>43</sup> The FERC maintained that ETP violated Market Behavior Rule 2 when it flooded the market with offers to suppress prices and took physical and financial positions that benefited from artificially low prices at Houston Ship Channel.<sup>44</sup> FERC ar-

gued that there was no legitimate reason for ETP to suppress prices in the gas market.<sup>45</sup>

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***The fact that show cause orders do not render final judgments provides little comfort to market participants struggling to decipher the scope of the FERC's anti-manipulation jurisdiction.***

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When the FERC issued the show cause orders, Chairman Kelliher released a statement emphasizing that the FERC “is not seeking to punish risk taking in energy markets” and noted that the FERC understands that investors take risks in these markets.<sup>46</sup> In addition, Chairman Kelliher focused on the nature of the show cause proceedings in which the FERC did not make final conclusions and the companies would have the opportunity to rebut the FERC’s preliminary conclusions.<sup>47</sup> However, the fact that show cause orders do not render final judgments provides little comfort to market participants struggling to decipher the scope of the FERC’s anti-manipulation jurisdiction and, in particular, the reach of the phrase “in connection with” in the Anti-Manipulation Rule.

#### **IV. Analytical Framework**

In developing a framework within which the FERC should apply reasonable self-limiting principles to its jurisdiction under the Anti-Manipulation Rule, it is important to consider the scope of the FERC’s jurisdiction in comparison to the CFTC’s jurisdiction. Historically, the FERC was a rate-setting agency that has evolved into an enforcement agency. It has exclusive jurisdiction over certain sales in interstate commerce of natural gas for resale and the sale of electric energy at wholesale. In contrast, the CFTC has exclusive jurisdiction over transactions involving contracts for the sale of a commodity (including natural gas and electricity) for future delivery.<sup>48</sup>

The EAct gave the FERC additional responsibilities to monitor and investigate energy markets

and use civil penalties and other means against energy organizations and individuals who violate the FERC’s rules in the energy markets. Because the CFTC and the FERC may engage in oversight or investigations of activity arguably implicating both CFTC-jurisdictional and FERC-jurisdictional transactions, Congress directed the agencies to enter into a Memorandum of Understanding to coordinate investigations pertaining to markets within the respective jurisdiction of each agency.<sup>49</sup> The MOU provides that the FERC and the CFTC shall coordinate discovery and proceedings in cases that pertain to both agencies jurisdiction, such as ETP and Amaranth. In their recent market enforcement actions, both the CFTC and the FERC have praised each other for the strong partnership through the MOU in coordinating investigations regarding market manipulation.<sup>50</sup> However, one wonders if, behind the scenes, the two agencies are engaged in hand-to-hand combat over their respective jurisdictions with energy companies caught in the middle.<sup>51</sup>

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***Dual federal enforcement actions involving the same conduct appear to serve little, if any, public policy benefit.***

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For purposes of enforcing anti-manipulation provisions, the FERC recognized in the ETP proceeding that the CFTC has jurisdiction insofar as NYMEX prices were affected and the FERC has jurisdiction insofar as physical prices of domestic gas sold for resale in interstate commerce were affected.<sup>52</sup> In areas where the jurisdiction of the two agencies may overlap, the FERC has emphasized Congress’ intent to give effect to both agencies’ jurisdiction.<sup>53</sup> Under the FERC’s broad interpretation of Congress’ intent, the agencies simultaneously can prosecute the same company for the exact same conduct in different forums. Dual federal enforcement actions involving the same conduct appear to serve little, if any, public policy benefit.

In order to limit duplicative enforcement actions, the FERC should not construe the phrase

“in connection with” under the Anti-Manipulation Rule to apply to the conduct of a party that itself does not engage in a FERC-jurisdictional transaction. As the court concluded in *Ontario*, conduct that merely “affects” a transaction should not be sufficient to satisfy standing requirements.<sup>54</sup> In other words, a party would need to enter into a transaction for the purchase or sale of wholesale natural gas or electricity to be subject to the FERC’s jurisdiction. Creating a precedent whereby two federal agencies can institute enforcement proceedings against the same party for the same conduct creates confusion among market participants and may deter them from engaging in legitimate business practices in the energy markets. Given the broad jurisdiction the FERC appears to have claimed under the Anti-Manipulation Rule, market participants likely will weigh the hefty regulatory risks associated with entering into energy transactions against the possible benefits of the transactions.

## V. Conclusion

While the show cause orders give market participants a small preview of how the FERC will apply its Manipulation Rule to particular trading strategies and factual circumstances, market participants still have little information about the scope of transactions over which the FERC intends to assert jurisdiction. There is no material public policy benefit from having two federal agencies prosecute (or investigate) the exact same conduct. To promote sound regulatory policy, provide market participants with reasonable notice and to conserve scarce federal resources, the FERC should develop and apply reasonable self-limiting principles to the exercise of its jurisdiction under the Anti-Manipulation Rule.

The primary self-limiting principle that the FERC should adopt is that it should refrain from construing the phrase “in connection with” to encompass the conduct of a party that itself does not engage in a FERC-jurisdictional transaction. The FERC also should exercise great care before alleging or concluding that conduct in one market “affects” the prices of FERC-jurisdictional transactions in another market. The relationships between prices of the same commodity at different

delivery points, spot and forward prices, financially and physically-settled transaction prices, and prices of related but different commodities are complex and affected by many factors. Adopting an overly simplistic view of the concepts of “nexus” and “affect” to satisfy the “in connection with” element of a manipulation violation is very likely to chill legitimate and beneficial market activity.

## NOTES

1. Market Behavior Rule 2 provided that: “[a]ctions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products are prohibited. Actions or transactions undertaken by Seller that are explicitly contemplated in Commission-approved rules and regulations of an applicable power market (such as virtual supply or load bidding) or taken at the direction of an ISO or RTO are not in violation of this Market Behavior Rule. Prohibited actions and transactions include, but are not limited to: (a) pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership (sometimes called “wash trades”); (b) transactions predicated on submitting false information to transmission providers or other entities responsible for operation of the transmission grid (such as inaccurate load or generation data; or scheduling non-firm service for products sold as firm), unless Seller exercised due diligence to prevent such occurrences; (c) transactions in which an entity first creates artificial congestion and then purports to relieve such artificial congestion (unless Seller exercised due diligence to prevent such an occurrence); and (d) collusion with another party for the purpose of manipulating market prices, market conditions, or market rules for electric energy or electricity products.” See *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations, Order Amending Market-Based Rate Tariffs and Authorizations*, 105 FERC ¶ 61,218 (2003), *reh’g denied*, 107 FERC ¶ 61,175 (2004) at Appendix A.

The analogous natural gas rule in Part 284 of the Commission’s regulations provided, in pertinent part: “(a) A pipeline that provides

unbundled natural gas sales service under Sec. 284.284 is prohibited from engaging in actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for natural gas. Prohibited actions and transactions include but are not limited to: (1) Pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership (sometimes called "wash trades"); and (2) collusion with another party for the purpose of manipulating market prices, market conditions, or market rules for natural gas. (b) To the extent Seller engages in reporting of transactions to publishers of electricity or natural gas indices, Seller shall provide accurate and factual information, and not knowingly submit false or misleading information or omit material information to any such publisher, by reporting its transactions in a manner consistent with the procedures set forth in the Policy Statement on Natural Gas and Electric Price Indices, issued by the Commission in Docket No. PL03-3-000 and any clarifications thereto. Seller shall notify the Commission within 15 days of the effective date of this regulation of whether it engages in such reporting of its transactions and update the Commission within 15 days of any subsequent change to its transaction reporting status. In addition, Seller shall adhere to such other standards and requirements for price reporting as the Commission may order. . . " Code of Conduct For Unbundled Sales Service, 18 C.F.R. §284.288 (2005).

2. Market Behavior Rule 2; 18 C.F.R. §284.288 (2005). In contrast to former Market Behavior Rule 2 and the analogous natural gas rule, the Commodity Exchange Act's anti-manipulation provisions only apply to conduct specifically intended to create an artificial price. See *In re Soybean Futures Litigation.*, 892 F. Supp. 1025, 1045, Comm. Fut. L. Rep. (CCH) P 26476 (N.D. Ill. 1995) (stating that the courts and the CFTC have adopted four necessary elements an accuser must prove to prevail on a manipulation claim: "(1) the defendant possessed the ability to influence prices, (2) an artificial price existed, (3) the defendant caused the artificial price and (4) the defendant specifically intended to cause the artificial price" (citing *Frey v. Commodity Futures Trading Com'n.*, 931 F.2d 1171, 1177-78 (7th Cir. 1991)); *Complaint for Injunctive and Other Equitable Relief and Civil Monetary Penalties Under*

*the Commodity Exchange Act* (N.D. Texas July 26, 2007) (alleging that defendants violated Sections 6(c), 6(d), and 9(a)(2) of the Commodity Exchange Act, 7 U.S.C. §§ 13(b) and 13(a)(2) (2006)).

3. Prohibition of Energy Market Manipulation, 114 FERC ¶ 61,047 at P 1 (Jan. 16, 2006) ("Anti-Manipulation Rule") (amending its regulations to implement new section 4A of the NGA and new section 222 of the FPA, prohibiting the employment of manipulative or deceptive devices or contrivances).
4. 16 U.S.C.A. § 824v; 15 U.S.C.A. § 717c-1.
5. 15 U.S.C.S. § 78j(b) ("Section 10(b)"). Congress did not require in the EPAct that the FERC adopt 17 C.F.R. §240.10b-5 ("Rule 10b-5"), including its material omission standard, in order to implement the EPAct's prohibitions against manipulation and fraud.
6. See Anti-Manipulation Rule; 16 U.S.C. § 791 *et al.* (2000); 15 U.S.C. § 717 *et al.* (2000).
7. Anti-Manipulation Rule, at P 49 (emphasis added).
8. The Anti-Manipulation Rule provides that "[i]t 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 [or the purchase or sale of electric energy or the purchase or sale of transmission services] subject to the jurisdiction of the Commission, (1) [t]o use or employ any device, scheme, or artifice to defraud, (2) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) [t]o engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity." 18 C.F.R. §§1c.1, 1c.2 (2007).
9. 18 C.F.R. §§1c.1(b), 1c.2(b) (2007) (stating "[n]othing in this section shall be construed to create a private right of action").
10. Anti-Manipulation Rule, at P 31.
11. For purposes of this article, "Amaranth" includes: Amaranth Advisors, L.L.C., Amaranth Advisors (Calgary) ULC and Brian Hunter; "ETP" includes Energy Transfer Company; ETC Marketing Ltd., and Houston Pipeline Company; and "Oasis Pipeline" includes Oasis Pipeline, L.P.; Oasis Pipeline Company Texas, L.P.; and ETC Texas Pipeline LTD., Oasis Division.
12. Contrary to the FERC's administrative show cause proceeding, the CFTC filed a complaint in the

U.S. District Court for the Northern District of Texas against ETP alleging that ETP attempted to manipulate the price of physical natural gas at the Houston Ship Channel delivery hub during September and November 2005 and attempted to manipulate Houston Ship Channel monthly index prices of natural gas published by Platts in its Inside FERC's Gas Market Report (Inside FERC) in October 2005 and December 2005. See *Complaint for Injunctive and Other Equitable Relief and Civil Monetary Penalties Under The Commodity Exchange Act*, available at, <http://www.cftc.gov/files/enf/07orders/enfetpcomplaint.pdf> (N.D. Texas July 26, 2007). The CFTC filed a complaint in the United States District Court for the Southern District of New York against Amaranth alleging that Amaranth intentionally and unlawfully attempted to manipulate the price of natural gas futures contracts on the NYMEX on February 24 and April 26, 2006. See *CFTC v. Amaranth Advisors, LLC*, No. 07 Civ. 6682 (S.D.N.Y. July 25, 2007). In both complaints, the CFTC is seeking permanent injunctive relief, an award of civil penalties, and other remedial and ancillary relief.

13. As of the date of publication of this article, Amaranth's request for rehearing is pending in the FERC proceeding. See *Request of Amaranth Advisors L.L.C., Amaranth Advisors (Calgary) ULC, Amaranth Management Limited Partnership and Amaranth Group Inc. For Expedited Rehearing To Terminate Show Cause Order For Lack of Subject Matter Jurisdiction*, Docket No. IN07-26-000 (filed Aug. 27, 2007). In the CFTC proceeding, Amaranth filed for motion for preliminary injunction asking the court to enjoin the FERC from proceeding with its enforcement action because the CFTC has exclusive jurisdiction over futures markets. On September 28, 2007, the FERC filed its opposition to Amaranth's Motion for Preliminary Injunction and argued, among other things, that judicial review of the Amaranth Show Cause Order lies exclusively with the Court of Appeals. See *The Federal Energy Regulatory Commission's Opposition to Defendants' Motion for Preliminary Injunction*, 07 Civ. 6682 (S.D.N.Y. Sept. 28, 2007) ("*Opposition to Preliminary Injunction*"). That same day, the CFTC submitted a Memorandum in Opposition to Amaranth's Motion to Stay the FERC Proceeding and argued that the extraordinary relief Amaranth requests is neither necessary nor proper and a mere attempt to forum shop on the jurisdictional issue. See *Plaintiff's Memorandum of Law in Opposition to Defendants' Motion for Preliminary Injunction Staying the Federal Energy Regulatory Commission*, 07 Civ. 6682 (DC) (S.D.N.Y. Sept. 28, 2007).
14. See Letter from U.S. Senators Dianne Feinstein, Maria Cantwell, and Ron Wyden to CFTC Acting Chairman, Walter Lukken (September 20, 2007).
15. On September 17, 2007, Senator Carl Levin, Chairman of the Permanent Subcommittee on Investigations, introduced a bill designed to close the so-called "Enron loophole" that allows electronic energy exchanges to operate outside federal regulation. See S.B. 2058 110th Congress (2007).
16. See Letter from U.S. Senator Norm Coleman to Agriculture, Nutrition and Forestry Committee Chairman, Tom Harkin (September 18, 2007).
17. See *id.*
18. *Order to Show Cause and Notice of Proposed Penalties*, 120 FERC ¶ 61,085 (July 26, 2007) ("*Amaranth Show Cause Order*"); *Order to Show Cause and Notice of Proposed Penalties*, 120 FERC ¶ 61,086 (July 26, 2007) ("*ETP Show Cause Order*"). The alleged manipulative conduct of ETP occurred before January 26, 2006, the effective date of new Anti-Manipulation Rule. Prior to this date, Market Behavior Rule 2 was in effect. While Market Behavior Rule 2 was enacted before EAct 2005, all violations of Market Behavior Rule 2 that occurred after the August 8, 2005 enactment date of EAct 2005 are subject to the maximum civil penalty provisions of section 314 of EAct 2005, which are \$1,000,000 per day per violation.
19. Statement of Chairman Joseph T. Kelliher on Anti-Market Manipulation Final Rule, available at <http://www.ferc.gov/news/statements-speeches/kelliher/2006/01-19-06-kelliher-M-1.pdf> (Jan. 19, 2006) (explaining that "[t]o be in violation of the new rules, however, such an entity must act with the requisite intent, and the fraud or deceit must be in connection with a transaction subject to the jurisdiction of the Commission, that is, the entity must affect a jurisdictional transaction.").
20. See Paul J. Pantano Jr. & Doron F. Ezickson, *FERC's New Anti-Manipulation Regime for Electricity and Natural Gas Transactions: Mixing Apples and Oranges*, Futures and Derivatives Law Report (March 2006).
21. In 1935, Congress passed the FPA and required the Federal Power Commission (the predecessor to the FERC) to set "just and reasonable" wholesale electricity prices.

22. However, the FERC itself has recognized that “unlike the SEC, which has broad jurisdiction over securities transactions, [FERC’s] jurisdiction is limited to certain wholesale transactions that remain within the ambit of the NGA, [Natural Gas Policy Act], and FPA.” See Anti-Manipulation Rule, at P 22.
23. *S.E.C. v. Zandford*, 535 U.S. 813, 819-820, 122 S. Ct. 1899, 153 L. Ed. 2d 1, Fed. Sec. L. Rep. (CCH) P 91795 (2002) (“Zandford”) (observing that the SEC has consistently “maintained that a broker who accepts payment for securities that he never intends to deliver, or who sells customer securities with intent to misappropriate the proceeds, violates § 10(b) and Rule 10b-5.”).
24. *U. S. v. O’Hagan*, 521 U.S. 642, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (1997) (“O’Hagan”). However, in *O’Hagan*, the court said the “in connection with” standard is met when the defendant “uses the information **to purchase or sell securities**” because the misappropriation theory “catches fraudulent means of capitalizing on such information **through securities transactions.**” *O’Hagan*, 521 U.S. at 656 (emphasis added).
25. *O’Hagan*, 521 U.S. at 656.
26. See *Zandford*, 535 U.S. at 819-820 (maintaining that to effectuate its remedial purposes Rule 10b-5 should be “construed flexibly, not technically and restrictively”).
27. Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (“SLUSA”).
28. *Sofonia v. Principal Life Ins. Co.*, 465 F.3d 873, Blue Sky L. Rep. (CCH) P 74600, Fed. Sec. L. Rep. (CCH) P 93981 (8th Cir. 2006) (“Sofonia”).
29. *Sofonia*, 465 F.3d 873.
30. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 126 S. Ct. 1503, 164 L. Ed. 2d 179, Blue Sky L. Rep. (CCH) P 74569, Fed. Sec. L. Rep. (CCH) P 93723 (2006) (“Dabit”).
31. *Dabit*, 547 U.S. at 84.
32. See *Dabit*, 547 U.S. at 85 (citing *Bragdon v. Abbott*, 524 U.S. 624, 645, 118 S. Ct. 2196, 141 L. Ed. 2d 540, 8 A.D. Cas. (BNA) 239 (1998)).
33. See Amaranth Show Cause Order at P 110 (stating “the “in connection with” language is drawn from similar language of Rule 10b-5 which has been very liberally construed. Accordingly, the Anti-Manipulation Rule applies where there is a “nexus” between the manipulative conduct and the jurisdictional transaction. Under the analogous Rule 10b-5 precedent, the alleged manipulator need not be a party to the jurisdictional nor must the connection be overwhelmingly direct transaction.”).
34. See *Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27 (2d Cir. 2004), cert. denied, 543 U.S. 1050, 125 S. Ct. 919, 160 L. Ed. 2d 771 (2005) (“Ontario”).
35. *Ontario*, 369 F.3d at 32.
36. *Ontario*, 369 F.3d at 34.
37. *Order to Show Cause and Notice of Proposed Penalties*, 120 FERC ¶ 61,085 (July 26, 2007) (“Amaranth Show Cause Order”); *Order to Show Cause and Notice of Proposed Penalties*, 120 FERC ¶ 61,086 (July 26, 2007) (“ETP Show Cause Order”).
38. Amaranth Show Cause Order at P108 (noting that the settlement price (i) directly sets the price for any contracts that ultimately go to delivery at Henry Hub, and (ii) directly incorporated into the price for physical basis transactions).
39. *Id.* In its *Opposition to Preliminary Injunction*, the FERC explained that “if the NG Futures Contract settlement price is affected due to manipulation, this effect will be directly and substantially transmitted into index prices. In turn, this index pricing ‘dominates the market for long- and mid-term supply agreements’ by such purchasers as Local Distribution Companies who sell natural gas to consumers to heat homes and fuel kitchens or electric utility companies who use natural gas to generate electricity for the Nation’s grid. In sum, manipulation of the NG Futures Contract settlement price has a direct and substantial effect on the prices used for huge quantities of physical natural gas – the type of ‘connection with’ the physical natural gas markets that the new anti-manipulation provisions from EPAAct 2005 were designed to redress.” *Opposition to Preliminary Injunction*, at 8-9.
40. Amaranth Show Cause Order at P 110. (stating “[u]nder the analogous Rule 10b-5 precedent, the alleged manipulator need not be a party to the jurisdictional transaction, nor must the connection be overwhelmingly direct.”) Contrary to the FERC’s interpretation of Rule 10b-5, the court in *Ontario* rejected plaintiff’s argument that Rule 10b-5 is intended to be construed “flexibly” and that the alleged misrepresentation by one company that merely “affected” the price of another company’s securities was insufficient to give the plaintiffs standing to sue under Section 10(b) or Rule 10b-5. See Amaranth Show Cause Order at P 110.
41. Amaranth Show Cause Order at P 110.

42. *Ontario*, 369 F.3d at 32-34.
43. ETP Show Cause Order at PP 1, 17. The FERC also directs Oasis Pipeline to show cause why the FERC should not find that Oasis Pipeline unduly discriminated against non-affiliated shippers, unduly preferred affiliated shippers and charged rates in excess of the maximum lawful rate for service under section 311 of the Natural Gas Policy Act of 1978. *Id.* at P2.
44. ETP Show Cause Order at P12.
45. ETP Show Cause Order at P35.
46. Chairman Kelliher Statement on Market Manipulation Show Cause Orders, available at <http://www.ferc.gov/news/statements-speeches/kelliher/2007/07-26-07-kelliher.asp> (July 26, 2007) ("July 26 Statement").
47. *Id.*
48. See Section 2 of the Commodity Exchange Act, 7 U.S.C. § 2(a)(1)(A) (2006) ("The Commission shall have exclusive jurisdiction . . . with respect to accounts, agreements . . ., and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated or derivatives transaction execution facility. . .").
49. Memorandum of Understanding Between the Federal Energy Regulatory Commission and the Commodity Futures Trading Commission Regarding Information Sharing and Treatment of Proprietary Trading and Other Information (dated Oct. 12, 2005) (the "MOU").
50. See July 26 FERC Press Release; *U.S. Commodity Futures Trading Commission Charges Hedge Fund Amaranth and its Former Head Energy Trader, Brian Hunter, with Attempted Manipulation of the Price of Natural Gas Futures*, CFTC Press Release, available at <http://www.cftc.gov/opa/enf07/opa5359-07.htm> (July 25, 2007) ("July 25, 2007 CFTC Press Release"). *U.S. Commodity Futures Trading Commission Alleges that Energy Transfer Partners, L.P. and Three of Its Subsidiaries Used the IntercontinentalExchange in Attempted Manipulation of Natural Gas Market*, CFTC Press Release, available at <http://www.cftc.gov/opa/enf07/opa5360-07.htm> (July 26, 2007) ("July 26, 2007 CFTC Press Release").
51. The two agencies battle for jurisdiction may become public in the Amaranth proceeding.
52. FERC Legal Authorities: ETP Show Cause, available at <http://www.ferc.gov/news/news-releases/2007/2007-3/07-26-07-etp-la.pdf> (stating "The CFTC has jurisdiction with respect to trading on organized exchanges such as NYMEX. The Commission has jurisdiction with respect to the price of domestic natural gas sole for resale in interstate commerce by a pipeline or an affiliate of a pipeline.").
53. Amaranth Show Cause Order at P48 (maintaining that "the law makes plain that the jurisdiction of the two agencies is to be complementary [and] [w]here the two regulatory regimes overlap, courts have concluded that Congress intended that both should be given effect").
54. See *Ontario*, 369 F.3d at 34 ("Stockholders do not have standing to sue under Section 10(b) and Rule 10b-5 when the company whose stock they purchased is negatively impacted by the material misstatement of another company, whose stock they do not purchase").





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