The Dodd-Frank Wall Street Reform and *Consumer Protection Act*

How are the Consumers Protected?

National Association of State Utility Consumer Advocates
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Orlando, Florida

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Dodd-Frank – Consumers Perspective Overview

- Express Consumer Protections – Primarily Lending
- Utilities – Primarily Derivatives Regulation
- Why Regulate Derivatives?
- Enforcement Powers – Who Governs What?
- Common Schemes
- New Costs to Utilities?
- Issues to Watch

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How Are Utilities Regulated?

- Lending provisions could affect credit policies
- Primary change is with regard to swaps and derivatives in general

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Express Consumer Protection Titles

- Prevent abusive consumer finance practices
- Title X – Consumer Financial Protection Act of 2010
  - New Bureau of Consumer Financial Protections
- Title XIV – Mortgage Reform and Anti-Predatory Lending Act
  - New Office of Housing Counseling

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Title VII - Derivatives

- Address gap in existing regulation
- 2000 Commodities Futures Modernization Act excluded Over The Counter Swaps from SEC and CFTC regulation
- Dodd-Frank regulates OTC swaps
  - SEC – Security Based Swaps
  - CFTC – All other Swaps, including energy swaps

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Post-Dodd-Frank Act

- SEC – Security-Based Swaps
- CFTC – All other Swaps
- FERC – Physical wholesale energy transactions and transmission/ transportation
- States – Retail energy transactions and deliveries

Why Regulate Derivatives?

- "Weapons of Mass Financial Destruction" (Buffett)
- Winners and Losers
- Historical Involvement in Costly Disruptions

Market Events & Enforcement Authorities

- Derivatives and Severe Financial Events Over The Past 20 Years
  - Municipal Bankruptcies or Losses
    - Orange County, California -1994 – ($1.6 B)
    - Wisconsin Investment Board – 1995 ($95 mil)
    - Arkansas Teachers Union – 1997 ($30 mil)
  - Long-Term Capital Management – 1998 ($4.6 B)
    - $1.25 trillion in derivatives
  - Enron – 2001 ($ 70 B ?)
    - Market Manipulation; Accounting Fraud; Derivatives Use and Abuse
  - Global Economic Crises of 2008-? ($ TRILLIONS ?)
    - Credit Default Swaps and Subprime Mortgages

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Expansion of Authority

- Post-Enron 2002
  - EPAct 2005 - Greatly Expanded FERC Authority
    - Market Manipulation Prohibited
    - Penalty Authority Increased
  - Sarbanes-Oxley – Corporate Accounting Reform
  - Calls for Stricter Regulation of Derivatives Went Unanswered
- Post-Financial Meltdown of 2008
  - Dodd-Frank Act
    - Expanded Regulation of Swaps
    - Broadened CFTC Enforcement Authority

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CFTC Statutory Authority

Pre-Dodd-Frank

- Market manipulation
  - Difficult burden of proof
    1. Ability to influence prices
    2. Specific intent to create artificial price
    3. Artificial price existed
    4. Defendant caused it

Dodd-Frank Expanded Authority

- Manipulative Devices
- Anti-Disruptive Practices
  - Bids/Offers
    - Buy Above / Sell Below Market
  - Disrupt Orderly Close
    - Bang The Close
  - Spoofing

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CFTC Policy Statements and Rules

- Final Rule
  - 180.1 – Manipulative and Deceptive Practices
  - 180.2 – Price Manipulation
- Policy Statement On Its New Anti-Disruptive Practices Authority
  - Bids and Offers
  - Disregard for Orderly Markets – e.g., “Banging the Close”
  - Spoofing

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Final Rule - Manipulative and Deceptive Practices

- July 14, 2011 – Adopts Rules 180.1 & 180.2
  - Dodd-Frank required rulemaking to implement revisions to 6(c)(1)
- Rule 180.1 Tracks Revised Section 6(c)(1) – Unlawful To
  - Use Manipulative Device
  - Engage in action that Operates as a Fraud
  - Make False Statements (e.g., crop reports)
- Reckless Standard – "Departs so far from the standard of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing"
  - Intent not required

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Final Rule - Price Manipulation

- Rule 180.2 –Tracks Pre-existing Standard
  - CFTC must prove
  - Ability, Intent and Actual Creation of Artificial Prices
- Reckless Not Enough – Must Prove Intent
- Attempted Price Manipulation Prohibited
  - No Need to Prove Actual Artificial Price for Attempt

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Anti-Disruptive Practices

- May 28, 2013 interpretive order
  - Explains How CFTC Intends to Apply New Section 4c(a)(5)

    [A] Buying Above Or Selling Below Market Is Per Se Violation
    - Disrupts Orderly Trading
    - Limited To Best Price On Facility – Not Entire Market

    [B] Disregard for Orderly Close
    - Any bids, offers, or orders that disrupt orderly trading during the close
    - Refused to limit to intentional – reckless is enough

    [C] Spoofing – bid or offer with intent to withdraw before execution
    - Order provides examples of conduct that would violate
    - Intent is required

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CFTC Penalty Authority

- Violations involving manipulation or attempted manipulation
  - $1 million per violation or 3 times gain (greater of)
- Other violations
  - $140,000 per violation or 3 times gain (greater of)
- Restitution
- Revocation of authority
- Criminal
  - Felony to engage in specified violations

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FERC Statutory Authority

- EPAct 2005 made it unlawful to manipulate energy markets
  - Intentional or Reckless
  - Fraudulent device or scheme
  - In connection with a jurisdictional transaction
- EPAct 2005 substantially increased FERC penalty authority
  - Fines apply for violations of all sections instead of limited sections
  - Fines increased from $5 or $10,000 to $1 million per day per violation
  - Criminal sentence increased from 2 to 5 years

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Restitution and Disgorgement

- FERC – Sometimes distributes disgorged profits to consumers
  - State agencies have been involved
- CFTC – Restitution if:
  - Harm proximately caused by violations
  - Equities
  - Complexity of establishing claims for individuals
  - Likelihood of customers getting relief on own
  - Ability to administer remedies
- Has ordered for investment fraud

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Comparison of CFTC and FERC Authorities

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Intent - Scienter

	CFTC	FERC
Manipulation	Reckless	Reckless or Intentional Affect on Jurisdictional Transaction
Price Manipulation	Intentional	N/A
Bid Offer	Strict Liability – No Intent	N/A
Disrupting Orderly Close	Reckless	N/A
Spoofing	Intentional	N/A

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Penalties per Violation

- $1 million per violation vs. $1 million per violation per day
  - Practical Difference?
  - CFTC views each act in furtherance to be a separate violation
    - Not time based
    - No practical difference if scheme involves acts each day

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Procedural Comparison

CFTC
- Many cases settle
- CFTC Eliminated its ALJs
- Most litigated cases filed Federal Court
- Judgment Officers – Can hear cases involving reparations

FERC
- Most cases resolved through settlement
- FERC Enforcement Litigation
  - Paper hearings
  - ALJs
- FERC Reviews all ALJ orders
- Paper Hearings
- Election to Challenge in U.S. Dist. Ct. de novo review (*Barclays*)

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Cases Applying Authorities

- CFTC Enforcement
  - Manipulation – *JP Morgan & Barclays*
  - Spoofing – *Panther Energy*
  - Position Limits – *Yadgir*

JP Morgan – What Did They Do?

- CFTC Case – Manipulative Device
  - Sold Massive Quantities Of Credit Default Swaps Just Before The Close
  - Protected Value Of Position By Pushing Price Down
  - Acted With Reckless Disregard –
    - No Need To Prove Intent
    - No Need To Prove Actual Affect On Price
  - $100 million penalty

JP Morgan – What Did They Do?

- FERC Case – Market Manipulation
  - Bidding Schemes - Take Advantage of Market Rules
  - Collect Excess Generator Compensation
  - $410 Million Combined Penalty And Disgorgement
    - Disgorgement Goes To The Market
    - Should Benefit Consumers

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Jurisdictional Overlap with FERC

- Cross-market manipulation
  - Manipulate physical energy price to benefit financial position (*BP Energy*, *Barclays*, *Energy Transfer Partners*)

    OR
  - Manipulate financial market to benefit physical energy position (*Amaranth/Hunter*)

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Consumer Exposure and Benefits

Costs of Hedging

- Compliance
  - Recordkeeping
  - Reporting
- Margin
  - Capital
- Uncertainty and Liquidity
  - Special Entities
  - Trade Options
  - Book Outs

Benefits

- Visibility
- Bona Fide Hedging
- Whistleblower Protections
- Stronger Enforcement = disincentives
- Internal Controls = prevention of abuse

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Margin

- Energy commodities not yet subject to clearing
- Exemptions for end-user – bona fide hedging
- No Clearing = No Mandatory Margin
- Speculative, non-hedge swaps may be subject to clearing and margin requirements

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End-User Exemption Clearing

- Non-Financial Entities
- Using swaps to hedge or mitigate commercial risk
  - Economically appropriate to reduce risk in conduct of a commercial enterprise
  - Risks arise from change in value of assets, services, products, etc.
- Elective
- Exemption from clearing only
- No exemption from recordkeeping and adds to reporting

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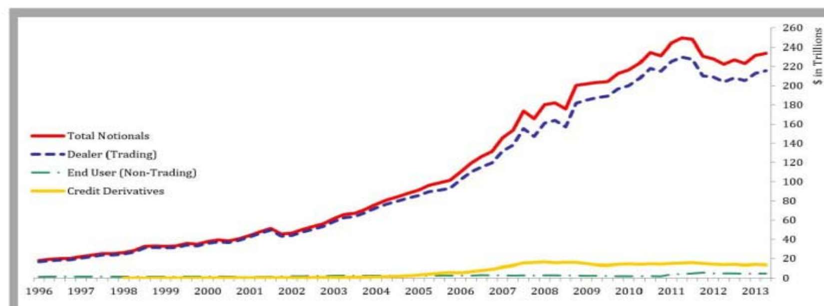
Graph 1

Derivative Notionals by Type of User

Insured U.S. Commercial Banks and Savings Associations



$ in Trillions	2006				2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Total Derivative Notionals	110.2	119.2	126.2	131.5	145.8	153.6	173.6	165.6	180.3	182.1	175.8	200.4	202.0	203.5	204.3	212.8
Dealer (Trading)	102.1	110.1	115.3	119.6	131.8	138.1	155.3	147.2	161.1	163.9	157.1	181.9	185.1	187.6	189.2	196.8
End User (Non-Trading)	2.6	2.6	3.0	2.8	2.9	2.6	2.8	2.6	2.8	2.8	2.6	2.6	2.3	2.4	2.1	2.0
Credit Derivatives	5.5	6.6	7.9	9.0	11.1	12.9	15.4	15.9	16.4	15.5	16.1	15.9	14.6	13.4	13.0	14.0

$ in Trillions	2010				2011				2012				2013	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Total Derivative Notionals	216.5	223.4	234.7	231.2	244.0	249.3	248.0	230.8	228.0	222.5	227.0	223.2	231.6	233.9
Dealer (Trading)	200.1	207.5	218.1	215.2	225.2	229.8	227.5	210.3	209.1	204.0	208.1	205.4	213.0	215.7
End User (Non-Trading)	2.0	2.0	2.1	1.9	3.9	4.3	4.8	5.8	4.8	4.8	4.9	4.6	4.7	4.8
Credit Derivatives	14.4	13.9	14.5	14.2	14.9	15.2	15.7	14.8	14.1	13.6	14.0	13.2	13.9	13.4

Note: Numbers may not add due to rounding. Total derivative notionals are now reported including credit derivatives, for which regulatory reporting does not differentiate between trading and non-trading.

Data Source: Call Reports.

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Issues to Watch

- RTO Transactions and Exemptions
- CFTC Data Management/Budget
- CFTC Coverage of Energy Commodities
  - Data Collection – CFTC ability to use data
  - Clearing – Energy Commodities
  - Book outs
- Shift to Futures
  - Block Trades & Position Limits
- Utility Compliance & CFTC Enforcement – Restitution?
- Jurisdictional battles between FERC and CFTC
  - Resolved by *Hunter*, or not
- Cases to watch
  - Barclays, BP Energy (overlapping jurisdiction)

Questions?

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Post-Dodd-Frank Act (Slide 6)

The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, H.R. 4173 (Jul. 21, 2010) ("Dodd-Frank Act") includes definitions of swaps and security-based swaps.

Section 721(a) of the Dodd-Frank Act defines the term ''swap'' by adding Section 1a(47) to the CEA, 7 U.S.C. 1a(47), which is also cross-referenced in new Section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69). The statutory definition of the term ''swap'' includes any 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.'' The term excludes forward contracts for delivery of non-financial commodities.

Section 761(a) of the Dodd-Frank Act defines the term ''security-based swap'' by adding new Section 3(a)(68) to the Exchange Act, 15 U.S.C. 78c(a)(68), which is also is cross-referenced in new CEA Section 1a(42), 7 U.S.C. 1a(42). The Dodd-Frank Act also explicitly includes security-based swaps in the definition of security under the Exchange Act and the Securities Act of 1933 (''Securities Act''), 15 U.S.C. 77a et seq. "Security-Based Swap is a swap that "is based on – (i) an index that is a narrow based security index, including [interest]; (ii) a single security loan, … or (iii) the occurrence or non-occurrence, or extent of occurrence of an event relative to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer."

The SEC and CFTC have issued joint rulemakings addressing these definitions. *See e.g.,* Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 156 (2012).

Why Regulate Derivatives? (Slide 7)

Warren Buffett's 2002 letter to Berkshire Hathaway shareholders famously described derivatives as "Financial weapons of mass destruction." He warned of derivatives value being dependent on credit-worthiness of counterparties, risks associated with collateral calls at a time when a company is in financial difficulty, the potential use of derivatives to improve reported earnings, and the difficulty of unwinding derivative transactions. The portion of his 2002 letter that addressed derivatives can be accessed here: Buffet on Derivatives.

Post-Enron Calls for Regulation (Slide 9)

According to testimony provided to Congress in 2002, Enron was primarily a derivatives trading company. *See* Testimony of Frank Partnoy Professor of Law, University of San Diego School of Law Hearings before the United States Senate Committee on Governmental Affairs, January 24, 2002. That instructive testimony can be located here: Partnoy Testimony

Professor Partnoy explained that Enron, while successful at trading derivatives in the market, also used derivatives to manipulate its financial reporting. Partnoy told Congress:

> *"Enron used derivatives and special purpose vehicles to manipulate its financial statements in three ways. First, it hid speculator losses it suffered on technology stocks. Second, it hid huge debts incurred to finance unprofitable new businesses, including retail energy services for new customers. Third, it inflated the value of other troubled businesses, including its new ventures in fiber-optic bandwidth. Although Enron was founded as an energy company, many of these derivatives transactions did not involve energy at all."*

Partnoy explains how Enron used derivatives transactions with its off balance sheet subsidiaries to hide debt and inflate the value of assets. One mechanism, a "price swap derivative," deflated the shares of Enron's stocks by requiring Enron to issue stock to the subsidiary/counterparty if either the inflated assets Enron transferred to it, or Enron's stock, lost value. Enron did not reflect the declines in value in its quarterly financial statements.

Partnoy was critical of "gatekeeper" institutions that failed to detect Enron's wrongdoing, including auditors, law firms, banks, securities analysts, independent directors, and credit rating agencies. He closes by urging Congress to consider regulating OTC derivatives.

Final Rule – Manipulative and Deceptive Practices (Slide 12)

On July 14, 2011, the CFTC adopted final rules implementing Section 753 of the Dodd-Frank Act. *Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation*, 76 Fed. Reg. 41398 (Jul. 14, 2011) adopting rule at 17 CFR Part 180 ("Adopting Release"). New Rule 180.1, implements CEA Section 6(c)(1) (addressing manipulative and deceptive conduct), and new Rule 180.2, implements CEA Section 6(c)(3) (addressing non-fraud based price manipulation).

Rule 180.1 – Applying Section 6(c)(1) Prohibition on the Employment, or Attempted Employment, of Manipulative or Deceptive Devices

Rule 180.1(a) tracks the statutory language and makes it unlawful to:

(i) use or employ, or attempt to use or employ, any "manipulative device, scheme or artifice to defraud";

(ii) make, or attempt to make, any "untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading";

(iii) engage, or attempt to engage, in any "act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person"; or

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(iv) knowingly or recklessly deliver or cause to be delivered a "false or misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the price" of a commodity.

Final Rule 180.2 – Prohibition on Price Manipulation

New Rule 180.2, which covers non-fraud-based price manipulation, adopts the text of new CEA Section 6(c)(3) verbatim, providing:

> *It shall be unlawful for any person,* ***directly or indirectly****, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity.*

The CFTC says its application of new Rule 180.2 will look to "the traditional four-part test for manipulation that has developed in case law arising under [CEA Sections] 6(c) and 9(a)(2)." *Id.* at 41407. Under this test, (1) a person must have the ability to influence market prices; (2) must have *specifically intended* to create or effect a price or price trend that does not reflect legitimate forces of supply and demand (recklessness applies for 180.1 but will not be sufficient under 180.2); (3) artificial prices must have existed; and (4) the person must have caused the artificial prices.

Anti-Disruptive Practices (Slide 14)

On May 28, 2013 the CFTC provided guidance on the scope and CFTC's application of its antidisruptive practices authority, under new Section 4c(a)(5) of the CEA, which was created by Section 747 of the Dodd-Frank Act. *Antidisruptive Practices Authority*, 78 Fed. Reg. No. 102, 31890 (May 28, 2013). Section 4c(a)(5) addresses "disruptive practices," making 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) the practice of bidding or offering with the intent to cancel the bid or offer before execution (commonly known as "spoofing").

While there are a number of details discussed in the guidance, the three categories can be generally described as follows.

(A) A person violates bids and offers by buying a contract at a price above the available offer, or selling below the highest available bid price regardless of intent because the conduct disrupts the foundation of fair and equitable trading.

(B) The CFTC explains how it will address actions which demonstrate disregard for the orderly execution of transactions during the closing period, prohibited by Section 4c(a)(5)(B), and provides examples of prohibited conduct that would disrupt that orderly market, including trading in a manner that recklessly or intentionally causes price divergence between a derivative and the underlying commodity, or which affects the spread between near months and remote months. One such example is a tactic known as

"banging the close," which the CFTC describes as "[a] manipulative or disruptive trading practice whereby a trader buys or sells a large number of futures contracts during the closing period of a futures contract (that is, the period during which the futures settlement price is determined) in order to benefit an even larger position in an option, swap, or other derivative that is cash settled based on the futures settlement price on that day." See CFTC Definition Banging the Close. The CFTC's *JP Morgan Chase* matter described below is an example of this practice.

Notably, under the amended Section 4c(a)(5)(B), recklessness is sufficient, which is a much easier standard for the CFTC to prove.

(C) The CFTC explains Spoofing, prohibited under Section 4c(a)(5)(C), is generally the placing of a bid or offer with the intent to withdraw it before execution. The CFTC's *Panther Energy* matter described below is an example of this conduct.

CFTC Penalty Authority (Slide 15)

The CFTC's enforcement authority involves three sections of the Commodity Exchange Act ("CEA") that were modified by the Dodd-Frank Act: (1) Section 4b provides authority to address contracts intended to cheat or defraud; (2) Section 6(c) prohibits manipulation and false information; and Section 9 makes it a felony to manipulate the price of any commodity or of any swap. These provisions are codified as follows: CEA Section 4b, 7 U.S.C. § 6b; CEA Section 6(c), 7 U.S.C. §§9 and 15, and CEA Section 9, 7 U.S.C. §13. The CEA provides the CFTC with authority to impose three forms of civil penalties.

First, for each statutory violation, the CFTC may impose a fine of $140,000 or three times the monetary gain resulting from the misconduct, whichever amount is greater. 7 U.S.C. § 9(10)(C)(i)(I) and (II).

Second, if the violation is market manipulation or attempted manipulation, the fine increases to $1,000,000 or three times the monetary gain resulting from the misconduct, whichever amount is greater. 7 U.S.C. § 9(10)(C)(ii)(I). Note Commissioner Chilton's concurrence in the CFTC's *JP Morgan* order describes this authority as "paltry."

Third, in addition to fines, the CFTC may order restitution to the aggrieved parties if the *damages are proximately caused* by the violations. *Id.* To impose restitution, the CFTC must determine the "practicality of this sanction [restitution] in the circumstances of a particular case." *In re Brian W. Ray*, CFTC Docket No. 30-11, at p. 30 (Feb. 18, 2011). This determination requires consideration of the following factors: "the equities weighing in favor of or against an order of restitution, the degree of complexity likely to be involved in establishing the claims of individual customers, the likelihood that the individual customers will obtain compensation through their own efforts, the ability of resources to administer restitution and any other matters that justice may require." *In re Staryk*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,206, at 45,812 n.15 (Dec. 18 1997).

The CFTC may also suspend, revoke, or permanently disqualify an individual's or firm's registration necessary to trade in futures markets. 7 U.S.C. § 9. Such a penalty is imposed if the violation threatens the integrity of the markets. *In re Staryk*, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,826, at 56,452 (July 23, 2004); *Miller I*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,440, at 42,914 (July 16, 1995).

FERC Statutory Authority (Slide 16)

The Energy Policy Act of 2005 ("EPAct 2005") significantly increased FERC's penalty authority. *See* Energy Policy Act of 2005 §§ 1284–85. FERC may impose civil penalties of up to $1,000,000 for each day the violation occurs. 16 U.S.C. § 825o-1. Violators are also subject to criminal penalties of up to $1,000,000 for each statutory violation. Penalties for regulatory violations may reach $25,000 for each violation. 16 U.S.C. § 825o. FERC can require profits to be disgorged, and has allocated those disgorged profits to customers in a number of cases. *See e.g., Energy Transfer Partners* and *JP Morgan Chase*, discussed below.

Cases Applying Authorities (Slide 22)

1. JP Morgan Chase Bank

On October 15, 2013, the CFTC announced a settlement between the CFTC and JP Morgan with regard to JP Morgan's use of a "manipulative device." *In the Matter of JP Morgan Chase Bank, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions*, CFTC Docket No. 14-01 (2013).

In essence JP Morgan banged the close and was sanctioned with a $100 million penalty. It held a $51 billion position in certain Credit Default Swap ("CDS") products. To protect that value and conceal losses, JP Morgan sold massive volumes of the product in the hours leading to the February, 2012 close. JP Morgan's sales on February 29, 2012, equaled 90% of the market volume for the day, and 15% of the volume for the entire month. The purpose of the large sales volume was to drive down the price, which "protected" JP Morgan's position. JP Morgan agreed to a civil penalty of $100 million. JP Morgan has assets in excess of 2 trillion, and the penalty is less than 0.5% of its $21.3 billion profits in 2012. The penalty pales in comparison to the $13 billion JP Morgan will reportedly pay to settle its involvement in mortgage securities, and another $4.5 billion it agreed to pay to institutional investors who bought mortgage back security products from JP Morgan.

The CFTC opines that, if its new supervision and control rules governing swap dealers "had been in effect in early 2012, JP Morgan would have been in a better position to detect" and manage the risks involved with its CDS positions. The CFTC notes that its new Section 6(c)(1) authority prohibiting manipulative or deceptive devices is designed to protect the market from devices that could interfere with legitimate market forces, either intentionally or recklessly. The CFTC concludes that JP Morgan's traders acted recklessly because it is very difficult to believe the traders were not aware of the possible consequence of selling enormous quantities of CDS products in a concentrated period at month-end. As such, the CFTC determines that JP

Morgan's conduct "falls squarely within the prohibitions of Section 6(c)(1) of the Act and Commission Regulation 180.1(a)."

Commissioners Chilton and O'Malia issued separate statements regarding the order, which place the order and the CFTC's new authority in context.. Commissioner Chilton concurs praising the CFTC's Enforcement Staff, and raising four points. First, he notes the authority applied here, created by the Dodd-Frank Act, provides the CFTC with much needed flexibility. He notes that its prior manipulation standard created "too high a hurdle" resulting in only one successfully litigated proceeding in the CFTC's 38 year history. Second, Chilton describes the CFTC's penalty authority as "puny," and seeks a statutory change. Third, he notes he would not have agreed to the settlement absent JP Morgan's admission to the findings of fault. Fourth, he notes that, even though the CFTC returned $1 billion to the Treasury the day before the federal government shutdown, the CFTC was generally closed and nobody was watching the markets during the shutdown. He called for Congress to allow the CFTC to use the funds it collects to fund its operations.

Commissioner O'Malia dissented for two reasons. First, he thinks the CFTC should have investigated further to determine if it could prove price manipulation instead of the lesser "manipulative device" charge. He criticizes the CFTC of rushing to reach a high-profile settlement instead of determining if JP Morgan can be shown to have intentionally or recklessly manipulated CDS prices (*i.e.,* O'Malia would have pursued a violation of Rule 180.2, which requires the CFTC to prove intent, instead of just 180.1, which can be violated through reckless conduct). Second, O'Malia is concerned with the lack of a clear definition of "manipulative device" in the order, and asserts that taking the case to court would have provided an opportunity to let the court clarify the meaning of the CFTC's new authority.

2. **Barclays PLC, *et al*., CFTC Docket No. 12-25**

On June 27, 2012, the CFTC issued an order instituting and resolving by settlement a proceeding addressing Barclays violations of CEA Sections 6(c), 6(d) and 9(a)(2), in relation to the London Interbank Offered Rate ("LIBOR") and Euro Interbank Offered Rate ("Euribor"). In return for the largest civil penalty ever issued by the CFTC - $200 million - the settlement resolves allegations that Barclays manipulated and made false, misleading or knowingly inaccurate submissions concerning the British Bankers' Association's ("BBA") LIBOR and the European Banking Federation's ("EBF") Euribor. Barclays purportedly did so itself, and in conjunction with others, in an effort to improve the value of Barclays' swap traders' derivatives trading positions, and to improve the investment community's image of its liquidity. The alleged manipulation and false statements took place between 2005 and 2009. The evidence included e-mails and other communications between traders and the Barclays personnel responsible for submitting rate information to LIBOR, in which the traders asked for specified ranges of rates to be submitted, and the submitting persons complied. Those communications are quoted extensively in the order.

3. Panther Energy Trading LLC/Coscia

In an order dated July 22, 2013, the CFTC announced its first application of its new Dodd-Frank disruptive trading authority. *In the Matter of Panther Trading LLC and Michael J. Coscia*, CFTC Docket No. 13-26 (July 22, 2013). The CFTC settled charges against Panther Energy Trading LLC and its principal, Michael Coscia, for engaging in "spoofing." The CFTC charged that Panther and Coscia used a computer algorithm that was designed to illegally place and quickly cancel bids and offers in futures contracts. Specifically, the computer algorithm was designed to place a small order which was then followed with several large buy orders. The large orders were intended to give the market the impression that there was buy side pressure. The small order would then be executed at the manipulated price and Panther's algorithm would then immediately cancel the large orders. These transactions occurred in milliseconds. The CFTC stated that "although Coscia and Panther wanted to give the impression of buy-side interest, they entered the large buy orders with the intent that they be cancelled before these orders were actually executed." The CFTC ordered Panther and Coscia to pay civil penalties of $1.4 million and to disgorge an additional $1.4 million in illegal profits. Coscia was also given a one year ban on trading in any CFTC regulated markets.

4. CFTC v. Yadgir

On November 5, 2013, the CFTC filed an action under Section 6c of the CEA, in the United States District Court for the Northern District of Illinois. Alleging Yadgir exceeded speculative position limits, the CFTC seeks a civil penalty, and a ban on future trading. This order demonstrates the CFTC's focus on individual traders as well as organizations.

JP Morgan - What Did They Do? (Slide 24)

FERC Actions

JP Morgan Chase & Co. Consent Agreement to Settle FERC Charges of Market Manipulation in CAISO and MISO, Docket Nos. IN11-8-000, IN13-5-000

On July 30, 2013, JP Morgan Ventures Energy Corp. ("JPMVEC"), a subsidiary of JP Morgan Chase & Co., with ownership of electric generator plants settled FERC's accusations that it manipulated electricity markets operated by the California Independent System Operator Corp. ("CAISO") and the Midcontinental Independent System Operator, Inc. ("MISO"). *JP Morgan Ventures Energy Corp.*, Docket Nos. IN11-8-000, IN13-5-000, 144 FERC ¶ 61,068 (July 30, 2013). Neither admitting nor denying the charges, JPMVEC agreed to pay a civil penalty of $285 million and disgorge $124 million to CAISO and $1 million to MISO. Those funds will be distributed to the markets, to customers.

According to FERC, JPMVEC engaged in twelve schemes that violated FERC's Anti-Manipulation Rule in the CAISO and MISO markets by intentionally submitted false bids to CAISO and MISO that tricked their software into thinking the bids were economic. These schemes involved gaming the day ahead and real time markets to force CAISO to pay JPMVEC excessive bid cost recovery payments. FERC determined that JPMVEC's bids were not based

on normal forces of supply and demand but, instead, were intended to create artificial conditions where JPMVEC would lose money in the day ahead and real time markets, triggering out-of-market compensation. As a result, JPMVEC allegedly interfered with the CAISO and MISO markets. CAISO and MISO responded to the gaming strategies by filing a series of emergency tariff change filings to prevent gaming going forward. To fashion the penalty, Enforcement considered JPMVEC's significant gains, intent, involvement of high level personnel, size, duration of conduct and failure to self-report. Additionally, Enforcement took the sizable losses incurred by CAISO and MISO and the harm suffered by FERC's jurisdictional markets into account. Enforcement ordered, and FERC accepted, that JPMVEC pay $285 million in civil penalties, $124 million in disgorgement to CAISO ratepayers and $1 million in disgorgement to MISO ratepayers.

Jurisdictional Overlap with FERC (Slide 25)

1. BP Energy, *et al.*, Docket No. IN13-15

On August 5, 2013, FERC issued a notice of penalty and order to show cause why BP America, Inc., BP Corporation North America, Inc., BP America Production Company, and BP Energy Company (collectively "BP") should not be found to have violated Section 1c.1 of FERC's regulations and Section 4A of the NGA. *BP America Inc.*, Docket No. IN13-15-000, 144 FERC ¶ 61,000, P 1 (Aug. 5, 2013) ("Order"). FERC's Staff alleged that BP traders from the Texas Southeast Gas Trading Desk ("Texas team") manipulated the price of physical natural gas at the Houston Ship Channel ("HSC") to benefit their financial position at HSC. FERC, adopting FERC Staff's recommendation, proposed fining BP $28,000,000 in civil penalties and disgorging $800,000 plus interest. FERC Staff alleged that from September through November 2008, the Texas team sold large quantities of next-day fixed-price natural gas at HSC at a loss, to suppress gas prices and widen the spread between the Texas team's HSC and Henry Hub positions.

According to FERC Staff, the sale of the large quantities of physical gas from Katy at HSC was uneconomic and inconsistent with the Texas team's normal arbitrage strategy. From September to November 2008, the Texas team consistently sold gas at HSC below the HSC and Katy daily prices. That is, the Texas team could have profitably sold at Katy, yet consistently sold gas at a loss at HSC. Concurrently, the Texas team built its long position at the Henry Hub, increasing its HSC – Henry Hub "swing spread" position. By suppressing prices at HSC and increasing the size of the spread, the Texas team increased their profits by over $5,000,000.

In addition to the trading data demonstrating allegedly uneconomic behavior, FERC Staff based their charges on phone recordings and the recent demotion of Gradyn Comfort, the leader of the Texas team. Comfort, according to OE Staff, was in need of a successful year as he had received a negative review in 2007, resulting in a demotion from the California desk to the Texas desk. On November 5, 2013, Clayton Luskie, a junior trader on the Texas team, called Comfort asking whether their decision to transport gas from Katy to HSC was based on "how we think it's going to affect the index and help our paper position." Comfort did not directly respond on the recorded call, but followed up though several cell phone discussions with Mr. Luskie. FERC Staff took this statement, and Comfort's response, to indicate that both parties understood their scheme was fraudulent.

Based on this evidence and its investigation, FERC Staff found that the Texas team violated FERC's anti-manipulation regulation Section 1c.1 and the NGA Section 4A. The anti-manipulation regulation prohibits an entity from: "(1) using a fraudulent device, scheme or artifice, or making a material misrepresentation or a material omission as to which there is a duty to speak under a Commission-filed tariff, Commission order, rule or regulation, or engaging 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 a transaction subject to the jurisdiction of the Commission." The Texas team committed fraud by using its physical long positions at Katy and HSC to suppress the physical price of natural gas at HSC. The phone conversations and the clear benefit to the Texas team's financial position by the increase of the HSC-Henry Hub spread demonstrated to OE Staff that the Texas team acted with *scienter*.

FERC asserted jurisdiction because the scheme involved "wholesale natural gas sales in interstate commerce and the scheme is "in connection with" FERC-jurisdictional sales, FERC has jurisdiction under Section 1c.1. The CFTC also investigated the conduct and notified FERC.

On September 9, 2013, BP responded with an Answer to the Show Cause order in which it challenged the assertions that it engaged in manipulation, challenged FERC's jurisdiction, and argued for dismissal. BP's jurisdictional argument does not claim CFTC jurisdiction. Rather, BP asserts that the transactions at issue are wholly intrastate, and therefore subject to Texas law, not FERC's jurisdiction.

2. Barclays, Docket No. IN08-8

On October 9, 2013, FERC filed a petition in Federal Court, seeking to enforce its July 16, 2013, Order Assessing Civil Penalties against Barclays Bank PLC ("Barclays"), and four of Barclays traders, for violating the FPA and the FERC's Anti-Manipulation Rule. *Barclays Bank PLC*, 144 FERC ¶ 61,041 (2013). FERC determined that, from November 2006 to December 2008, Barclays and the four traders conspired to manipulate the daily electricity index price on FERC-jurisdictional physical markets in order to benefit Barclay's futures swap positions. FERC ordered Barclays to pay an unprecedented $435 million in civil penalties, and to distribute $34.9 million in unjust profits to the Low Income Home Energy Assistance Project for four states. FERC ordered the four traders to pay civil penalties ranging from $1 million to $15 million.

According to FERC, Barclays and the four traders engaged in a scheme that involved the accumulation of large volumes of fixed-price physical electricity products at four markets in the western United States in a position that was opposite to the financial, futures swaps positions Barclays had established. As a bank, FERC determined Barclays did not have the ability to actually deliver or receive the obligations under these physical products. [This finding is inconsistent with common contract terms, and may have implications under the end-user exemption.] However, Barclays contract rates enabled it to trade for an equal volume of next-day physical products, called "Dailies," to "flatten"—*i.e.* cancel out—Barclay's physical obligations. FERC determined that Barclays' intent when flattening its physical positions was to manipulate the index price in the direction that benefited Barclays' futures swaps.

FERC rejected Barclay's claim that FERC had no jurisdiction to regulate the physical products at issue. According to FERC, these physical products were encompassed in FPA Section 222's broad authorization to penalize any entity who "directly or indirectly . . . use[s] or employ[s], *in connection with the purchase or sale of electric energy . . . subject to the jurisdiction of the Commission*, any manipulative or deceptive device or contrivance." In FERC's view, the physical products involved in these transactions distinguished Barclays' activity from the violations in *Hunter v. FERC*, where the District of Columbia Circuit Court of Appeals held that the CFTC had exclusive jurisdiction over futures markets. In Barclays' case, the manipulative trading occurred in physical markets, and the scheme manipulated the physical price of electricity. In contrast, *Hunter* involved manipulative trading in a futures market. According to FERC, the fact that the Barclays' scheme was ultimately designed to benefit Barclays' CFTC-jurisdictional futures contracts was immaterial because the fraudulent conduct occurred outside futures markets. Additionally, FERC found that Barclays' manipulative trading directly harmed and affected the integrity of FERC-jurisdictional wholesale energy markets.

After FERC issued its show cause order, Barclays utilized a procedure under which an accused entity can bypass a FERC proceeding, and challenge FERC's allegations in a court proceeding. FERC's October 9, 2013, Petition to enforce the order initiates that *de novo* review.

Actions Involving Both FERC and CFTC

1. Energy Transfer Partners, 120 FERC ¶ 61,086 (2007).

Both FERC and the CFTC pursued actions against Energy Transfer Partners ("ETP"), addressing ETP's manipulation of physical natural gas markets at the Houston Ship Channel (HSC) delivery point to benefit its financial positions.

a. FERC Show Cause

FERC issued a show cause order alleging that ETP manipulated gas markets, and proposing civil penalties totaling $82 million, plus disgorgement of $69.8 million of unjust profits. FERC determined ETP set up its financial and physical portfolio to profit from lower prices at HSC. ETP then sold physical gas for delivery at HSC for less than a competitive price. FERC states ETP's HSC manipulations affected the Platts *Inside FERC* ("IFERC") HSC index for monthly natural gas. Many physical and financial contracts are priced by reference to the IFERC index at various locations, including the HSC. In spite of ETP's sales activity at HSC, it was consistently a net buyer of monthly gas priced at the IFERC HSC index, and thus was positioned to benefit from the lower price it caused in the months it manipulated fixed-price sales at HSC. ETP also entered into financial transactions known as basis swaps (that reference the New York Mercantile Exchange ("NYMEX") futures contract to leverage its benefit from suppressing monthly physical prices at HSC.

FERC explained that entities that sold physical gas to ETP at the artificially-reduced IFERC HSC index were harmed by ETP's downward trading manipulations. FERC also noted that in addition to producers, royalty owners and taxing authorities were harmed by the artificially-

reduced prices, and that counterparties in the referenced financial basis transactions were also harmed.

After proceeding towards trial, ETP ultimately entered into a settlement under which it agreed to pay a total of $30 million to resolve the FERC proceeding. Those funds were distributed to market participants through a FERC governed process.

b. CFTC v. ETP. Commodities Futures Trading Commission v. Energy Transfer Partners, et al., 3:07-cv-01301 [N.D. Tex].

The CFTC filed a complaint in the United States District Court for the Northern District of Texas, alleging that ETP and three of its subsidiaries attempted to manipulate the price of natural gas for delivery at the HSC by selling on the Intercontinental Exchange ("ICE") massive quantities of natural gas for delivery at HSC, with the intent of placing downward pressure on natural gas prices at HSC. The CFTC also alleged that ETP's reporting of those transactions to *Inside FERC Gas Market Reports* ("*Inside FERC*"), was an attempt to manipulate the HSC index price of natural gas published by *Inside FERC* to benefit their financial basis swap positions tied to the *Inside FERC* HSC natural gas index prices.

In a settlement announced on March 17, 2008, the ETP defendants agreed to pay a $10 million penalty to settle the CFTC's action. The CFTC's press release announcing that settlement thanked FERC for its cooperation in that matter. That cooperative spirit stands in stark contrast with the agencies' jurisdictional scuffle in the Amaranth/Hunter proceeding.

2. Amaranth Advisors, *et al.*

FERC and the CFTC both pursued enforcement actions against Amaranth and its head trader, Brian Hunter, alleging that Amaranth manipulated the financial natural gas markets to benefit its physical natural gas positions. This is the inverse of ETP and BP Energy's schemes, where the physical was manipulated to benefit financial positions. Both FERC and the CFTC initiated actions. Amaranth reached settlements with both agencies, which FERC accepted due to Amaranth's deteriorating financial condition. The head trader, Brian Hunter, challenged FERC's jurisdiction, and ultimately prevailed in court on jurisdictional grounds. In *Hunter v. Federal Energy Regulatory Commission*, the United States Court of Appeals for the District of Columbia held that the CFTC has exclusive jurisdiction over natural gas futures contracts, and FERC's authority under EPAct 2005 does not vest FERC with authority to regulate natural gas futures markets, or to penalize someone who manipulates natural gas futures markets.

The court's recitation of facts states that Brian Hunter, a futures trader at Amaranth, manipulated the New York Mercantile Exchange natural gas futures market by selling a massive amount of gas futures contracts—constituting between 14.4%-19.4% of market volume—at strategic times. This resulted in artificial declines in the price of natural gas. Hunter's portfolio was positioned to benefit from these price decreases.

Because Section 2(a)(1)(A) of the CEA granted the CFTC "*exclusive jurisdiction* . . . with respect to . . . any transactions involving contracts of sale of a commodity for future delivery,

traded or executed on a contract market," the court held that only the CFTC had jurisdiction over transactions on futures markets like the New York Mercantile Exchange. Although EPAct 2005 authorized FERC to pursue violations "in connection with" jurisdictional transactions, it cannot do so when the violation is within the exclusive jurisdiction of the CFTC. Here the violations that were in connection with FERC's jurisdictional transactions were futures transactions, subject to the exclusive jurisdiction of the CFTC. (The CFTC has a case pending against Brian Hunter that was stayed during the appeals from FERC's orders.)

End-User Exception (Slide 28)

On July 29, 2012, the CFTC issued a Final Rule defining the end-user exception. *End-User Exception to the Clearing Requirement for Swaps; Final Rule*; 17 CFR Part 39, 77 Fed. Reg. 134. In simple terms, non-banks that are end users of commodities can elect to not clear swaps that are used to hedge commercial risks. The election to not clear does not exempt transactions from reporting or record keeping requirements, and in fact it increases those obligations.

Derivatives Data (Slide 29)

The Office of the Comptroller ("OCC") publishes information regarding derivatives held by insured banks. The chart on slide 29 comes from the OCC's quarterly report on derivatives for the second quarter of 2013, which can be accessed here: OCC Quarterly Derivatives Report 2nd 2013.

Issues to Watch (Slide 30)

CFTC Budget

The CFTC has asked for a 50% increase in its budget to cover the cost of addressing its new responsibilities under Dodd-Frank, but that is proving difficult with Congress: CFTC Budget Article 10 31 2013.

Book Outs

Forward energy transactions, which contractually bind the parties to make or take physical delivery, are excluded from the definition of a swap. Further Definition of "swap," etc., 77 Fed. Reg. No. 156, 48208 at 48227 (August 13, 2012). If a forward energy contract is ultimately settled financially instead of being physically delivered it does not lose its status as a forward energy transaction, and become a swap, **so long as** the facts and circumstances satisfy three "safe harbor" criteria (*Id.* at 48228-29):

(1) The original contract must create a binding obligation to make or take delivery;

(2) The book-out must be reflected in a separate, individually negotiated agreement; and

(3) The agreements must be entered into between Commercial Market Participants in connection with their business.

With regard to the third element, the CFTC has indicated that all parties in the chain of delivery for each transaction must be Commercial Market Participants, which are entities that "regularly make or take delivery of the referenced commodity in the ordinary course of their business." (*Id.* at 48229) The CFTC explained that a hedge fund taking delivery of gold as part of an investment strategy would not qualify as a Commercial Market Participant, but a gold mine or jewelry manufacturer would. An unanswered question remains as to whether or not an energy market participant with no physical assets can make and take delivery in a fashion that satisfies this test. That is, do entities like banks that participate in the energy markets qualify as Commercial Market Participants because they can make or take delivery by executing transactions, schedules and e-tags with transmission providers, organized markets and/or pipelines? If not, are all transactions in which they are in the chain of title susceptible to being regulated as swaps if the transaction is booked out? While it was not expressing a view on the CFTC's standards, FERC's order in Barclays, discussed above, casts a shadow on this issue by stating that Barclays, as a financial player, did not have the ability to make or take delivery.

Swaps Converted to Futures

While central-cleared futures markets are the model for the OTC swaps regulation under Dodd-Frank, many entities are moving into futures instead of swaps to avoid the burdens of the new rules. Platts swaps to futures article July 1 2013. See also, ICE Moves to Futures 7 31 2012. One potential reason for the shift is the differing treatment of block-trades, with no minimum size for futures.

Speculative Position Limits

The CFTC recently reinstated position limits that were overturned by a court last year. On November 5, 2013, the CFTC issued an announcement of new proposed speculative position limits: Press Release. Commissioner Chilton issued a separate statement supporting the limits as necessary in light of the Bear Sterns failure: Chilton Statement. Commissioner O'Malia issued a dissent: O'Malia Dissent.

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Questions?

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