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FERC Issues $30 Million Penalty for Alleged Violations of Anti-Manipulation Rule

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On April 21, 2011, the Federal Energy Regulatory Commission (FERC) issued an Order Affirming Initial Decision and Ordering Payment of Civil Penalty in connection with an Administrative Law Judge's (ALJ) Initial Decision that a natural gas trader for Amaranth, Brian Hunter, engaged in market manipulation, in violation of Section 4A of the Natural Gas Act (NGA) and Part 1c.1 of FERC's regulations.[1] The case focused on Hunter's trading activities in natural gas futures contracts (NG Futures Contracts) on the New York Mercantile Exchange (NYMEX). FERC's Order affirmed the Initial Decision of the ALJ and assessed a civil penalty against Mr. Hunter in the amount of $30 million. FERC's Order represents the first fully litigated proceeding involving FERC's enhanced authority to investigate allegations of and penalize instances of market manipulation, which FERC received following the enactment of the Energy Policy Act of 2005. Further, FERC's Order likely sets the stage for subsequent legal challenges to FERC's claimed jurisdiction.

In its Order, FERC determined that Hunter's trading strategy concerning NG Futures Contracts in February, March, and April 2006 was developed in a manner that was designed to lower the settlement price of NG Futures Contracts in order to benefit Hunter's positions on other trading platforms and generate a profit on related financial instruments, including large short positions maintained by Amaranth in natural gas swaps. In affirming the ALJ's Initial Decision, FERC alleged that Hunter's conduct satisfied all three elements of a market manipulation claim, as required by Section 4A of the NGA and Part 1c.a of FERC's regulations. FERC asserted that the ALJ correctly determined that Hunter's trading strategy in February, March, and April 2006 constituted market manipulation because (1) it involved the use of a fraudulent scheme (2) with the requisite scienter and (3) in connection with a FERC-jurisdictional transaction.

Fraudulent Scheme: In finding that Hunter's trading strategy constituted fraudulent conduct, FERC focused on the fact that prior to the violations, Hunter rarely sold significant numbers of NG Futures Contracts during the settlement period in months prior to February, March, and April 2006. However, FERC explained that during the settlement period in February, March, and April 2006, Amaranth, as a result of Hunter's trading strategy, accounted for 19.4%, 15.0%, and 14.4% of the market volume, respectively. FERC further asserted that Hunter's large sell orders (at prices below those of other traders and the volume-weighted average price) forced his brokers to hit their bids, which almost guaranteed a lower price. This in turn "exerted downward pressure on the market and created prices that were not the

1. *Brian Hunter*, 135 FERC ¶ 61,054 (2011).

result of normal supply and demand." Contemporaneously, as explained by the ALJ and affirmed by FERC, Amaranth amassed large swap option positions on other trading platforms that would benefit from falling NG Futures Contract settlement prices. Hunter was compensated based on trading desk profitability and could achieve incentive bonuses based on whether he exceeded prior year's profits.

FERC identified four factors in support of its finding that Hunter's activity formed a fraudulent scheme: (1) the change in the volume of trades executed by Hunter during the settlement period in February, March, and April 2006 compared to the volume of trades executed prior to those months; (2) the execution of sell orders at prices below those of other traders; (3) Hunter's amassing large swap positions on other trading platforms that would benefit from falling NG Futures Contract settlement prices; and (4) that Hunter was compensated, in part, based on trading desk profitability. FERC alleged that Hunter's conduct violated the Anti-Manipulation Rule because it involved high-volume trading for the purposes of controlling prices rather than in response to legitimate supply and demand, with an external purpose of benefiting other positions owned by the alleged manipulator.

FERC also rejected arguments by Hunter that false statements are required in order to determine that a fraudulent scheme exists, instead clarifying that false statements are not required for a manipulation claim. Further, FERC reaffirmed its assertion that "open-market transactions send false information into the marketplace if such transactions are undertaken with the intention of creating a false price." The existence of an artificial price, however, is not a necessary element of a manipulation claim. FERC reasoned the difference between legitimate open-market transactions and illegal open-market transactions "may be nothing more than a trader's manipulative purpose for executing such transactions."

Requisite Scienter: Turning to the second element required under Section 4A of the NGA and Part 1c.1 of FERC's regulations, FERC claimed that Hunter possessed the requisite scienter because he believed the NYMEX settlement price could be manipulated, understood that his positions on other trading platforms would benefit from a lower NG Futures Contract settlement price, sold a significant volume of NG Futures Contracts during the settlement period (despite being advised to reach a flat position prior to the expiration day), employed a trading strategy that differed significantly from ones utilized in prior periods, and possessed a financial motive to drive down the NG Futures Contract settlement price.

FERC asserted that regardless of whether the manipulative trading strategy was the primary driver of Hunter's portfolio, the strategy was still profitable, and thus Hunter possessed a financial motive to manipulate. In addition, Hunter's deviation from prior trading strategy constituted further evidence of intent to manipulate. Though FERC noted that evidence of a prior trading strategy would not, by itself, necessarily support a finding of scienter, it was reasonable for the ALJ to rely on the stark departure from established trading patterns (which when repeated created a "pattern of conduct") as one piece of evidence showing intent to manipulate. Addressing Hunter's contentions that he did not act with the requisite scienter to support a finding that he engaged in market manipulation, FERC explained that it "agree[d] with the ALJ's conclusion that Hunter's explanations of his conduct are not credible and amount to after-the-fact defense of his actions."

Jurisdictional Transactions: Although Hunter's trading activities involved financial instruments rather than physical sales of natural gas, FERC alleged that the third element required for a market manipulation claim was satisfied because Hunter intended to affect, or acted recklessly to affect, a jurisdictional transaction. FERC asserted the third element of a market manipulation claim does not require FERC's Office of Enforcement to demonstrate that the manipulator's principal or exclusive purpose is the manipulation of physical natural gas sales. Rather, the Office of Enforcement need only demonstrate that there is a "nexus between the manipulative conduct and the jurisdictional transaction." FERC reasoned that given the interconnections between the futures market and the physical market, "any manipulation of the settlement price of NG Futures Contracts would affect FERC-jurisdictional transactions."

Determination of Penalty: In determining the appropriate penalty to assess against Hunter, FERC considered the parameters set forth in a 2005 Enforcement Policy Statement.[2] That policy statement identified a series of factors to be considered in assessing the seriousness of alleged violations and any mitigating factors that may reduce the civil penalty assessment. In applying the policy statement to Hunter's activity, FERC determined that a $30 million civil penalty was appropriate. In reaching its conclusion, FERC first considered each individual sale of a NG Futures Contract as a violation of the NGA and of FERC's regulations prohibiting market manipulation. Second, FERC considered the seriousness of the alleged offense, and determined that Hunter's "violations were extremely serious and thus warrant a significant penalty." FERC explained that Hunter's conduct rose to a level of extreme seriousness because it was felt by a significant portion of physical gas market participants, constituted intentional manipulation, and was undertaken by senior management because Hunter served as a vice president of the Amaranth hedge fund and as the president of Amaranth Calgary.

Turning to mitigating factors, FERC considered the extent of Hunter's commitment to compliance, cooperation, and degree to which he self-reported the alleged manipulative activity. In doing so, FERC determined that Hunter knew of and disregarded Amaranth's internal prohibition of marking the close in an effort to alter the value of an existing position. Further, FERC determined that Hunter did not demonstrate exemplary cooperation during the course of the investigation, but instead provided testimony that the ALJ determined to lack candor and credibility. Finally, FERC noted that neither Hunter nor Amaranth self-reported the violations.

Collectively, FERC's consideration of these aggravating and mitigating factors warranted, in FERC's determination, the assessment of a $30 million penalty.

Implications of FERC's Order

FERC has asserted jurisdiction over alleged manipulative transactions involving financial instruments, such as NG Futures Contracts. Such an assertion of jurisdiction by FERC may well continue to create tension with the Commodity Futures Trading Commission (CFTC). Further, although FERC's Order represents the first fully litigated proceeding concerning allegations of manipulative behavior in alleged violation of the NGA and FERC's regulations, FERC's jurisdictional assertions are likely to result in subsequent legal challenges through a Request for Rehearing at FERC and a subsequent challenge before a federal court.

Hunter has previously challenged FERC's assertion of jurisdiction over his financial instrument trading activity. However, in December 2010, the U.S. Court of Appeals for the D.C. Circuit dismissed Hunter's Petition for Review as unripe for review.[3] In the proceeding, the CFTC intervened in support of Hunter,

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2. In 2010, FERC issued a Revised Policy Statement on Penalty Guidelines. However, FERC did not consider the Revised Policy Statement on Penalty Guidelines in the instant proceeding because that Policy Statement does not apply to natural persons. *See* 135 FERC ¶ 61,054 at n. 247; *see also Revised Policy Statement on Penalty Guidelines*, 132 FERC ¶ 61,216 at PP 59, 62 (2010).

3. *See Brian Hunter v. FERC*, No. 10-1017, slip op. at 2 (D.C. Cir. Dec. 22, 2010) (per curiam).

arguing that FERC did not possess jurisdiction to address trading activity concerning financial instruments. However, the D.C. Circuit determined that since FERC had not issued an order constituting final agency action, the D.C. Circuit was unable to assert jurisdiction over any challenges to FERC's legal authority to address the allegation lodged against Hunter. Following FERC's April 21 Order, legal challenges to FERC's assertion of jurisdiction over financial instrument trading are expected.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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