Papers

Amaranth advisors and the FERC's regulatory authority

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Practical applications

This paper is useful for traders, compliance officers and legal counsel to hedge funds and other end users who execute transactions in commodities in the United States. Specifically, it highlights concerns with regulatory oversight of the transactions that are entered into with a settlement price that is established with reference to prices of futures contracts. As regulators in the United States discuss with greater scrutiny the oversight of derivatives instruments, this paper addresses one issue in a complex landscape.

Abstract

The 'Commodity Futures Trading Commission' (CFTC) has changed Amaranth Advisors, LLC ('Amaranth') and its former head trader with manipulation of the natural gas futures market. On the same set of facts, the 'Federal Energy Regulatory Commission' (FERC) has issued an order to show causes asserting that Amaranth intentionally manipulated the price of natural gas futures contacts. One issue at the centre of these proceedings is whether the FERC has the authority to issue the order to show cause on the facts present in the Amaranth case or whether it has overstepped its authority. This paper will provide a brief overview of the natural gas markets and explain the relationship between the physical gas market and the futures gas market. The scope of the CFTC's jurisdiction and the FERC's jurisdiction over the natural gas market is addressed as well as whether the FERC should have jurisdiction over Amaranth and its traders who were trading exclusively on the futures market.
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INTRODUCTION

On 25th July, 2007, the Commodity Futures Trading Commission (CFTC) charged hedge fund Amaranth Advisors, LLC (Amaranth) and its former head energy trader, Brian Hunter, with intentional and unlawful manipulation of the natural gas futures market.[1] In its complaint, the CFTC alleges the attempted manipulation of the price of the New York Mercantile Exchange (NYMEX) Natural Gas Futures Contract (NG Futures Contract) on two occasions: on 24th February, 2006 and 26th April, 2006.[2] On 26th July, 2007, the day after the charge, the Federal Energy Regulatory Commission (FERC) issued an order to show cause on the very same facts.

The facts as presented in the CFTC complaint are as follows. On 23rd February, 2006, the defendant, Brian Hunter, instructed another Amaranth trader to be certain that Amaranth acquired sufficient futures to sell during the closing range on the next day.[3] Before the last 30 min of trading on 24th February, 2006, Amaranth had reversed its March 2006 NYMEX NG Futures Contract positions from being short more than 1,700 to being long on more than 3,000 March 2006 NYMEX NG Futures Contracts.[4] Amaranth then sold the March 2006 NYMEX NG Futures Contracts during the closing range.[5] All the while, Amaranth held large short natural gas financially settled swap positions on the Intercontinental Exchange (ICE). This large short position is relevant because, as the complaint noted, the settlement price for ICE swaps is based on the NYMEX NG Futures Contract settlement price.[6]

On 26th April, 2006, a few days before the May 2006 NG Futures Contract expiry day, Amaranth again reversed its May 2006 NYMEX NG Futures Contract positions from being short to being long in excess of 3,000 May 2006 NYMEX NG Futures Contracts.[7] During the closing range, Amaranth sold its May 2006 NYMEX NG Futures Contracts. With this sale, Amaranth attempted to lessen the impact of a buyer who intended to purchase a large number of NYMEX NG Futures Contracts, which would have adversely affected Amaranth's short swap positions on the ICE.[8]

In its Complaint, the CFTC alleges that the defendants intended to lower the price of the NYMEX NG Futures Contract to benefit their larger swap positions on the ICE.[9] Additionally, the CFTC also alleges that Amaranth attempted to cover up its actions by making false statements to NYMEX.[10] The CFTC is seeking permanent injunctive relief, an award of civil penalties, and other remedial and ancillary relief as is necessary, and contends that the court has jurisdiction over this matter pursuant to Section 6(c) of the Commodity Exchange Act (CEA), which authorises the CFTC to seek injunctive relief against any person who violates or is violating any provision of the Act.[11]

On 26th July, 2007, the FERC issued an order to show cause on the same set of underlying facts, asserting that Amaranth intentionally drove down the price of natural gas futures contracts.[12] The FERC, which is responsible for the regulation of the interstate transmission of natural gas, alleges that Amaranth's manipulation of the futures market 'had a significant impact on physical markets' over which the FERC has jurisdiction.[13] The FERC alleges that this, in turn, 'had a significant impact on physical markets, given the role of the Natural Gas Futures settlement price in physical market price formation, thereby affecting a substantial volume of FERC jurisdictional natural gas transactions'.[14] In the order to show cause, the FERC alleges that Amaranth and its traders intentionally manipulated the NYMEX NG Futures Contract to produce artificial settlement prices[15] and also alleges that the traders manipulated the price knowing that the settlement price is used to price the physical market.[16] The FERC specifically charged Amaranth with violating its anti-manipulation rule prohibiting the employment of 'any device, scheme or artifice to defraud' and engaging 'in any act, practice or course of business that operates or would operate as a fraud or deceit upon any entity'.[17] Finally, the FERC is seeking remedies for these violations, including civil penalties and disgorgement of profits.[18]

At the centre of this debate is the question of whether the FERC has the authority to bring an action against Amaranth based on the exact same set of facts at issue in the CFTC complaint. In the first part of this paper we provide a brief overview of the natural gas markets and an explanation of the relationship between the physical gas market and the futures gas markets. The second part of this paper discusses the scope of the CFTC's jurisdiction. The third part addresses the FERC's jurisdiction over the natural gas market and discusses the issues created by the implementation of the anti-manipulation provisions of Energy Protection Act of 2005 (EPAct).[19] The final part of this paper comments on the issues raised by the FERC's exercise of jurisdiction over Amaranth and its traders who were trading exclusively on the futures market.

OVERVIEW OF THE NATURAL GAS MARKET

Natural gas futures are financial instruments that provide for the sale of natural gas at a specified delivery point, for a specified price, at some specified time in the future. The price for natural gas futures contracts is customarily established with reference to the settlement price of the NYMEX NG Futures Contract.[20] The NYMEX NG Futures Contract hence provides price transparency and a very liquid trading mechanism for natural gas contracts. It also affords the opportunity for those trading on the physical market to hedge against risks of future price volatility. The actual delivery of natural gas is not necessarily contemplated in the futures market. In the vast majority of the cases, participants in those markets simply trade and offset their positions, and rarely seek the physical delivery of natural gas. Like other futures contracts, the vast majority of NG Futures Contracts do not in fact go to delivery.

The link between the physical market and the financial market has grown recently. For instance, the physical trades have involved more physical-basis deals. In these transactions, buyers and sellers reference the NYMEX settlement price for physically traded natural gas contracts, as opposed to using the traditional method of referencing the published indexes. The FERC has expressed concern on seeing this increased reliance on the NYMEX NG Futures Contract settlement price. In its State of the Markets Report of 2006, the FERC discussed the relationship between the physical and financial markets in the following terms:

> 'As a practical matter, monthly cash physical and futures natural gas prices are and must be closely related to one another, if markets are

working effectively. The fact that many participants can engage in both futures and monthly cash physical markets means that any material differences will be arbitraged away. That is, at least some market participants will pick the least expensive way to establish a position using different combinations of products. In doing so, they will force the values of those different combinations to converge. Consequently, big changes in cash physical market values naturally affect futures trading, and vice versa'.[21]

This relationship between the financial market and the physical market is the basis for the FERC's contention that it should have jurisdiction over Amaranth.

JURISDICTION OF THE CFTC

Before the enactment of the CEA of 1974, the commodities markets were regulated by the Commodity Exchange Authority,[22] the Securities Exchange Commission (SEC) and other regulatory agencies. Market participants had to deal with a duplicative regulatory structure where multiple regulators had overlapping jurisdiction and authority. In passing the CEA, Congress sought to do away with the contradictory regulatory scheme and centralise authority in one agency with specialised expertise over the futures industry. Pursuant to Section 2(a)(1)(A) of the CEA, Congress granted the CFTC exclusive jurisdiction over the regulation of the commodity futures and option markets.[23] This includes the natural gas futures markets. This grant of exclusive jurisdiction was intended to help prevent conflicting rulings on the same subject matter, thus enabling market participants to trade under a more streamlined regulatory structure.[24] Unless otherwise stipulated by Congress, no other federal or state agency is to have authority to regulate futures contracts.

In addition to the grant of exclusive jurisdiction, Section 7 of the CEA mandates the CFTC with the responsibility 'to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options…'[25] The CFTC's broad enforcement authority permits it to take action against any person who is

> 'manipulating or attempting to manipulate or has manipulated or attempted to manipulate the market price of any commodity, in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or has willfully made any false or misleading statement of a material fact in any registration application or any report filed with the Commission … or otherwise is violating or has violated [the Commodity Exchange Act or any CFTC rule]…'[26]

We should add that the courts have determined that in order for the CFTC to bring an enforcement action for market manipulation in respect of any conduct it must establish that (i) there was an ability to influence market prices, (ii) a false price was created; (iii) the alleged wrongful conduct caused the artificial price; and (iv) the wrongdoer acted willfully and knowingly.[27]

JURISDICTION OF THE FERC

Pursuant to the Natural Gas Act (NGA) and the Federal Power Act (FPA), the FERC is responsible for regulating the transport, sale and other uses of electricity, oil and natural gas.[28] Additionally, the FERC is charged with ensuring that prices in these markets are fair and reasonable.[29] Since its inception, the FERC has been considered primarily a regulatory agency with limited enforcement authority. Between the years of 2000 and 2001 the western United States suffered a significant energy crisis, which, however, led to Congress' enactment of the EPAct.[30] In its staff report of March 2003, the FERC found that a significant reason for the energy crisis was market manipulation.[31] As a result, Congress granted the FERC additional authority under the EPAct to investigate and punish market manipulation activities.[32] In doing so, Congress provided the FERC with the authority to issue regulations prohibiting

> '[A]ny 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 … 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'.[33]

Additionally, the EPAct added a new section, 4A, to the NGA, whereby it made it unlawful for any entity to use 'any manipulative or deceptive device or contrivance' to infringe the rules and regulations of the FERC.[34] This section of the NGA makes it illegal for any entity to use manipulative or deceptive devices or contrivances 'in connection with the purchase or sale of natural gas, or of transportation services subject to the jurisdiction of the Commission'.[35]

When it enacted the EPAct of 2005, Congress specifically stated that '[n]othing in this Section may be construed to limit or affect the exclusive jurisdiction of the [CFTC] under the [CEA]'.[36] On 12th October, 2005, the CFTC and the FERC entered into a memorandum of understanding regarding the sharing of information and the confidential treatment of proprietary energy trading data, pursuant to the Energy Policy Act of 2005 (the 'Memorandum of Understanding').[37] The FERC specifically recognised the CFTC's exclusive jurisdiction over futures contracts in connection with the Memorandum of Understanding.[38] Nonetheless, upon the enactment of the EPAct, the FERC created its own anti-manipulation regulations and patterned them after the SEC's anti-manipulation rule, Rule 10b-5. The FERC's anti-manipulation rule prohibits manipulation and fraud in the electricity and natural gas markets. The rule prohibits any entity from engaging in manipulation that is 'in connection with' an FERC jurisdictional transaction, whether intentionally or recklessly.[39] In conjunction with the adoption of the anti-manipulation rule, the FERC also issued Order No. 607. This set out the elements that need to be proven to bring about a manipulation claim: 'an entity (1) … engages in an 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 and sale of natural gas … subject to the jurisdiction of the Commission'.[40]

With the promulgation of these rules, the FERC's entry into the world of market manipulation, and the possibility of multiple, conflicting regulatory systems governing the same conduct in the same markets, was an immediate cause for concern. Even though the EPAct expressly preserved the jurisdiction of the CFTC under the CEA, and FERC expressly agreed, pursuant to the Memorandum of Understanding, not to bring duplicative actions under the same matters, the FERC is presently seeking to bring an action against Amaranth, based on the exact same conduct at issue in the challenge asserted by the CFTC against the hedge fund. This first exercise of the FERC's new anti-manipulation authority under the EPAct will establish ground rules for the foreseeable future.

FERC'S JURISDICTION OVER AMARANTH

In *Amaranth*, the defendants traded in the natural gas futures market. They did not buy or sell physical natural gas. Nonetheless, the FERC is seeking to prosecute the hedge fund under its anti-manipulation rules for an alleged manipulation that took place exclusively in the futures markets, not the physical natural gas market, over which the FERC does have jurisdiction. Relying upon the EPAct amendments that empower the agency to punish manipulation by any entity 'in connection with' jurisdictional transactions, the FERC seeks to send the message that any manipulative activity that has an effect on the physical gas market will be a target for enforcement scrutiny and prosecution.

The FERC contends that manipulation and false reporting are merely conduct and not 'contracts, agreements or transactions', over which the CFTC does have jurisdiction, as provided in the CEA.[41] The FERC suggests that the CFTC's exclusive jurisdiction is limited to the regulation and adjudication of the 'day-to-day aspects of futures trading, such as the terms or conditions of sale of NG Futures Contracts, the operating rules of the NYMEX exchange or traders' commodity accounts'.[42] Applying this reasoning, the FERC further contends that pursuant to the EPAct the FERC was vested with the power to bring an action for manipulation where conduct impacts the price of transactions that are within the FERC's jurisdiction. Since futures market prices are used to set physical market prices, the FERC concludes that it is empowered to bring cases based solely on futures market trading, such as the one against Amaranth.

Historically, the imperfect juxtaposition of jurisdiction and authority over the futures market has been the basis of many CFTC cases. However, the courts have substantially concluded that Congress' intent is that where the CFTC does have authority to regulate, it regulates exclusively.[43] The FERC's administrative action is analogous to the SEC actions that the courts have dismissed is the past. The NYMEX NG Futures Contract is a 'contract of a sale of a commodity for future delivery' as provided in the CEA.[44] Therefore, the NG Futures Contract falls entirely within the exclusive jurisdiction of the CFTC. Further, any alleged manipulation of the market price of an NG Futures Contract falls within the purview of the CFTC's enforcement jurisdiction against any person who attempts to manipulate the market and should be scrutinised under the CFTC's four-part test for establishing a manipulation claim.

New litigation by the FERC, in addition to the already pending claim by the CFTC, could bring about duplicative rulings, or worse, contradictory rulings over the same matter. The threat of inconsistent judgments from claims involving the exact same facts, with two distinct procedural and evidentiary standards, will cause Amaranth as well as other funds in similar situations in the future to have to deal with the uncertainty this creates. In addition to any risk of unjust and inequitable treatment of the parties involved, the very efficiency of the markets could be jeopardised. Should the FERC be permitted to proceed with its administrative action, it seems to us that the very situation Congress sought to avoid by granting exclusive jurisdiction to the CFTC over futures markets will be frustrated.

Notes

1 *U.S. Commodity Futures Trading Commission* vs *Amaranth Advisors, LLC*, 2007 U.S. Dist. LEXIS 80978, at *2 (S.D.N.Y. 1st November, 2007).
2 These were the last days of trading for the given futures contract, which days are known as the 'expiry day' of the contract.
3 Complaint for Injunctive and other Equitable Relief and Civil Monetary Damage Penalties under the Commodity Exchange Act at 6, *Amaranth*, 2007 U.S. Dist. LEXIS 80978 (07 CIV 6682).
4 Complaint at 6, *Amaranth* (07 CIV 6682).
5 *Id.* at 5. The closing range is the last 30 min of trading for a given contract on an expiry date. The settlement price of a NYMEX NG Futures Contract is determined by the volume weighed average of the trades executed during the closing range (between 2:00–2:30 p.m.) on the expiry day of such contracts.
6 Complaint at 5–6, *Amaranth* (07 CIV 6682).
7 *Id.* at 9.
8 *Id.* at 9–10.
9 See, *Id.* at 1 (summarising the allegations against Amaranth).
10 *Id.* at 1–2.
11 Commodity Exchange Act §6, *codified at* 7 U.S.C. §6 (2007).
12 *Amaranth*, 2007 U.S. Dist. LEXIS 80978, at *3.
13 *Amaranth*, 2007 U.S. Dist. LEXIS 80978, at *8 (quoting, FERC Mem. 13).
14 *Id.*
15 Order to Show Cause and Notice of Proposed Penalties at 3, *Amaranth*, 2007 U.S. Dist. LEXIS 80978 (IN07-26-000).
16 *Id.* at 3.
17 *Amaranth,* 2007 U.S. Dist. LEXIS 80978, at *3.
18 Order to Show Cause at 65, *Amaranth* (IN 07-26-000).
19 Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594.
20 NYMEX Exchange Rulebook §220.01, *available at* http://www.nymex.com/rule_main.aspx?pg=33. The NYMEX NG Futures Contract is a contract for future delivery of natural gas at the Henry Hub that is traded on the NYMEX.
21 FERC's 2006 State of the Markets Report at 48, *available at*, http://www.ferc.gov/market-oversight/st-mkt-ovr/som-rpt-2006.pdf.
22 The Commodity Exchange Authority is the predecessor of the CFTC.
23 Commodity Exchange Act, §2(a)(1)(A), *codified at* 7 U.S.C. 2(a)(1)(A).
24 See, *S.E.C.* vs *Amer. Commodity Exch., Inc.*, 546 F. 2d 1361, 1369 (10th Cir. 1976) (holding that it was Congress' intent to avoid overlapping jurisdiction over the futures markets); see also, *Fairchild, Arabatzis & Smith, Inc.* vs *Prometco*, 470 F. Supp. 610, 614 (S.D.N.Y. 1979) (providing that the legislative history of the Commodity Exchange Act of 1974 establishes that Congress' intent was that commodity options be relegated by only one agency with specific expertise in the area).
25 'About the CFTC', *available at* http://www.cftc.gov/aboutthecftc/index.htm.
26 7 U.S.C. §9 (2007).
27 See, *In re Soybeans Futures Litigation*, 892 F.Supp. 1025, 1045 (N.D. Ill. 1995) (adopting the four elements of a manipulation claim under section 9(a) of the CEA).
28 Natural Gas Act, 15 U.S.C. §717 (2007); Federal Power Act 205-206, 16 U.S.C. 824 (Supp. 2004).
29 *Id.*
30 Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594.
31 See, FERC Staff Report, Final Report on Price Manipulation in Western Markets: Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, Docket No. PA02-2-000, *available at* http://www.ferc.gov/industries/electric/indus-act/wec.asp (concluding that 'supply-demand imbalance, flawed market design and inconsistent rules made possible significant market manipulation').
32 See, Energy Policy Act of 2005, §315, §1283 (amending the NGA and the FPA to grant the FERC enforcement powers to prohibit market manipulation of natural gas).
33 Energy Policy Act of 2005, §315, *codified at* 15 U.S.C. §717c-1.
34 *Id.*
35 *Id.*
36 Energy Policy Act of 2005, §316, *codified at* 15 U.S.C. § 717t-2(c)(2).
37 See, Memorandum of Understanding between the Federal Energy Regulatory Commission (FERC) and the Commodity Futures Trading Commission (CFTC) Regarding Information Sharing and Treatment of Proprietary Trading and Other Information, *available at*

http://www.ferc.gov/EventCalendar/Files/20051020121515-MOU.pdf (Memorandum of Understanding) (stating that if Congress had intended to expand the FERC's jurisdiction, 'it would have done so explicitly').

38 Memorandum of Understanding.

39 Prohibition of Energy Market Manipulation, 18 C.F.R. § lc.l, issued in Order No. 670, 114 FERC 61,047 (19th January, 2006).

40 *Id*.

41 The Federal Energy Regulatory Commission's Opposition to Defendant's Motion for a Preliminary Injunction, *Amaranth* (07CIV6682(DC)).

42 *Id*.

43 See, for example, *S.E.C.* vs *Amer. Commodity Exch., Inc.*, 546 F. 2d 1361, 1369 (10th Cir. 1976) (holding that it was Congress' intent in passing the Commodities Exchange Act of 1974 to avoid overlapping jurisdiction); *see also*, *E.F. Hutton & Co.* vs *Schank*, 456 F. Supp. 507, 513 (D. Utah 1976) (holding that the CFTC has exclusive jurisdiction over the commodities future market); see also, *S.E.C.* vs *Univest, Inc.*, 405 F. Supp. 1057, 1058 (N.D. Ill. 1976) (concluding that Congress, by creating the CFTC, essentially eradicated the SEC's jurisdiction over commodity futures contracts); see also, *Chicago Mercantile Exchange* vs *SEC*, 883 F.2d 537 (7th Cir. 1989), *cert. denied Investment Co. Inst.* vs *SEC*, 496 U.S. 936 (1990) (holding that the CFTC's exclusive jurisdiction over the futures market precludes the SEC's jurisdiction over instruments that are both securities and futures contracts).

44 Commodity Exchange Act, §2(a)(1)(A), 7 U.S.C. 2(a)(1)(A); see also, NYMEX Exchange Rulebook §220.01 (defining the NG Futures Contract).