Market Manipulation post Hunter vs. FERC: A Framework for Unified Analysis

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There is need for clarity of manipulation rules

♦ Major problem in separating manipulative cause and effect:
  • In competitive markets, traders are “price-takers” who react to market events, the result of which has little effect on the market
  • In reality, the requisite assumptions of competition may be lacking, allowing traders to bias market outcomes (e.g., a price) to benefit related positions that are valued by those outcomes

♦ There is need for a practical way to distinguish behavior that serves a stand-alone, legitimate business purpose from that which is considered potentially manipulative:
  • Unclear standards complicate compliance, potentially decreasing market liquidity by chilling legitimate trades
  • False positives may lead to wrongful allegations requiring vigorous legal defense at great expense to firms and individual traders

♦ Knowledge of what is manipulative would provide clarity for compliance and certainty for enforcement

♦ Clarification of a manipulation standard would ideally relate manipulation analysis to analyses of fraud and antitrust
A wide variety of behavior can trigger a manipulation

♦ The FERC and CFTC’s recent anti-manipulation cases focused on the use of **uneconomic behavior**:
  - Energy Transfer Partners
  - Amaranth Advisors and Brian Hunter
  - Constellation
  - Deutsche Bank
  - DiPlacido
  - Optiver

♦ The DOJ’s *Keyspan-Ravenswood* decision considered a case first brought before the FERC as a market manipulation, but triggered by **withholding** (award of disgorgement as damages – a first for the DOJ)

♦ Litany of SEC and CFTC cases involving **outright fraud** (e.g., “pump & dump” schemes, ponzi schemes) and uneconomic trading (e.g., “marking the close,” “framing the open”)

♦ There is need for a common analytical construct across these cases, agencies, statutes, and (given new EU provisions) continents
One way to explain the cause and effect of manipulation is to separate the analysis into a framework of three pieces:

- A trigger – Acts intended to directionally bias a market outcome
- A target – One or more position(s) that benefit from that bias
- A nexus – A provable linkage between the trigger and target

For example, triggers of a price-based manipulation are:

- Transactions that intentionally lose money to alter a price
- Statements or actions that misrepresent value to alter a price
- Use of market power to alter a price

Targets of a price-based manipulation could be:

- Physical commodity TAS (a.k.a. priced “at index”)
- Financial derivatives positions
- Other related market positions

The nexus of the manipulation could be any reference price, including a price determined from an index or auction.
A framework to analyze price-based manipulation

**Manipulation Triggers**
- Uneconomic Trading
- Outright Fraud
- Exercise Market Power

**Nexus**
- Biased Market
- Reference Price

**Manipulation Targets**
- Financial Derivatives
- Physical “At Index”
- Cross-Market Positions

**Manipulation Profits**
Things that make a successful manipulation more likely

♦ Cheaper triggers (measured on a stand-alone basis):
  • Uneconomic trading requires the manipulator to bear some cost of the manipulation (i.e., transactional fraud)
  • Outright fraud allows the manipulator to trick others into bearing the full cost of the manipulation
  • The manipulator actually profits from the exercise of market power

♦ The ability to acquire greater leverage in targeted positions:
  • Large physical market traded “at index” or TAS
  • Explosion of trading in derivatives and speculation in energy futures provides many venues from which to assemble positions
  • Explains ability of large financial players to manipulate markets

♦ Greater inelasticity of supply and/or demand:
  • Lack of sufficient market liquidity magnifies this effect
  • Energy markets are ripe for manipulation given reliance on price indices, access to derivatives and complex product relationships
Hypothetical analysis of an alleged manipulation

1. **Trigger**
   - Do the actions in question involve fraud, uneconomic behavior, or an abuse of market power?
     - Yes → Legitimate Business Purpose
     - No → Target

2. **Target**
   - Did the trader hold financially leveraged positions that could profit from the manipulation?*
     - No → No Manipulation Likely*
     - Yes → Nexus

3. **Nexus**
   - Does a sufficient nexus exist between the manipulation trigger and target?
     - Yes → Legitimate concerns of manipulative behavior
     - No → No Manipulation

*Not all financial positions may be observable.
All components of the manipulation are CFTC jurisdictional, so no question as to its ability to prosecute the manipulation.

FERC claimed jurisdiction based on “in connection with” language of NGA as NG settlement price is used to value many physical natural gas contracts.

Appellate decision confirms CFTC’s exclusive jurisdiction over the instruments it regulates.
All components of the manipulation are FERC jurisdictional, so no question as to its ability to prosecute the manipulation.

Dodd-Frank states that its provisions do not affect the FERC’s jurisdiction over the RTOs.

CFTC has granted a public interest exemption to the RTOs.

Potentially large number of RTO instruments otherwise could be construed as CFTC jurisdictional - everything but real-time transactions may be futures or swap contracts.
Questions as to enforcement authority may arise when the instruments involved cross jurisdictional boundaries:

- How can the FERC bring an enforcement action when the Target of the manipulation is CFTC jurisdictional?
- How can the CFTC bring an enforcement action when the key leg of the HSC Basis Swaps position is FERC jurisdictional?
Concluding thoughts

♦ The Brian Hunter decision tends to validate the perspective that jurisdiction in future manipulation cases will run with the instruments/processes regulated (cf. Arlington vs. FCC)

♦ The framework could provide structural consistency for the analysis and proof/disproof of manipulation across cases, instruments, agencies, and continents (EU has same rules)

♦ However, jurisdictional conflicts concerning oversight over different instruments/processes may frustrate the ability to create such consistency:
  • Heightened concern of duplicative prosecution and false positives:
    ■ Aggressive but legitimate trading could be mistaken for intentionally manipulative behavior
    ■ Legitimate hedging can be mistaken as a manipulation target
    ■ Loose or spurious cross-market interactions could be mistaken as nexuses gamed by opportunistic trading
  • Heightened concern of ineffective deterrence and false negatives
Additional reading


♦ Other documents are available at Dr. Ledgerwood’s web site
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The Brattle Group provides consulting and expert testimony in economics, finance, and regulation to corporations, law firms, and governments around the world.

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- Transmission
Dr. Ledgerwood specializes in issues of market competitiveness with an emphasis on the economic analysis of market manipulation. He previously served as an economist and attorney for the FERC in its enforcement proceedings involving Energy Transfer Partners, L.P. and Amaranth Advisors, LLC. He has built upon these experiences to develop a framework for defining, detecting and analyzing manipulative behavior. He has worked as a professor, economic consultant, attorney, and market advisor to the regulated industries for over twenty years, focusing on issues including ratemaking, power supply, resource planning, and electric asset valuations. In his broader practice, he specializes on issues in the analysis of liability and damages for actions based in tort, contract or fraud. He has testified as an expert witness before state utility commissions and in federal court.