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THE BEST DEFENSE IS A GOOD OFFENSE: A PRACTICAL FRAMEWORK FOR ANALYZING AND DOCUMENTING TRANSACTIONS AND TRADING STRATEGIES TO LIMIT REGULATORY LIABILITY

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"If you tell the truth, you don't have to remember anything," Mark Twain famously wrote.[1] Twain obviously never had his conduct second-guessed after-the-fact by a government regulator. Nor did he have the benefit of modern memory research, which questions the usefulness of recollection in judicial processes.[2] False or faulty memory is an annoyance we all experience in banal ways, but the research shows that it can also be common in much more consequential scenarios—for example, recalling why you pursued a particular trading strategy a couple years ago. Was it because of market fundamentals? Which ones? Which were the most important?

These questions, and many others, arise in fraud and manipulation investigations by the Federal Energy Regulatory Commission ("**FERC**"), the Commodity Futures Trading Commission ("**CFTC**"), other federal agencies and self-regulatory organizations ("**SROs**") such as commodity exchanges. They often must be answered without the benefit of clear contemporaneous evidence that could refresh the respondent's recollection, or even convince the regulator to end the inquiry.

Regulators may not discuss memory studies in their orders, but their actions demonstrate great skepticism about the usefulness of memory in resolving enforcement actions. It is possible that instead of questioning memory generally, regulators simply believe that respondents are lying about their past intent. The reality, regardless of the reason, is the same: the FERC, CFTC and SROs regularly disregard *post-hoc* explanations of lawful intent in favor of inferences of unlawful intent based upon circumstantial evidence.

Contemporaneous evidence of good faith is particularly valuable in defending enforcement actions in today's regulatory environment. But it is often hard to come by. Traders do not typically document their thinking with legal precision, if at all. Consequently, available contemporaneous intent evidence is often too unclear to change a zealous regulator's point of view. For this reason, recent FERC and other agency guidance counsels that documenting transactions and strategies is a

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hallmark of an effective compliance program.[3] Developing a commercially workable approach to such analyses and documentation, however, presents significant challenges.

In this article, we translate the current regulatory guidance into a commercially workable framework for considering how to analyze and document transactions and strategies. We begin with the relevant legal standards and guidance. In light of that guidance, we then set forth and discuss in detail our proposed framework in the following five steps:

- First, we identify, in a non-exhaustive list, the types of transactions and strategies that might warrant this type of review and/or documentation.
- Second, we discuss who should be involved in the review and analysis of the proposed transaction or trading strategy.
- Third, we provide guidance for how to conduct the analysis.
- Fourth, we identify key considerations for whether, and how, to document the transaction or strategy.
- Fifth, we discuss whether, and how, to implement ongoing monitoring of the transaction or strategy.

We conclude with general recommendations for analyzing and documenting transactions and strategies in light of this framework and relevant regulatory guidance.

I. Regulatory Guidance Recommends Documenting Transactions and Strategies

Many events have begun to alter the historical resistance among companies proactively to document transactions and strategies. Regulators are more aggressive and seek large penalties for regulatory violations. Some agencies tout criminal sanctions and imprisonment as a desired deterrent. The former Chairman of the CFTC argued in a December 10, 2014, speech that, "there is no stronger deterrent against future misconduct than the possibility of criminal sanctions, including prison."[4] The Department of Justice ("**DOJ**") has articulated a similar sentiment.[5] In our experience, zealous government attorneys also are more skeptical of market participants and their hindsight rationalization for certain trading behaviors.

In addition, FERC staff now specifically recommends documenting strategies and transactions.[6] While FERC's compliance guidance is the most developed, it is generally consistent with the CFTC's and DOJ's positions. Because FERC staff have set forth detailed guidance in writing, we refer mainly to it, but the recommendations can be applied to compliance programs generally, including to the compliance programs of entities whose activities are regulated by other agencies.

A. *Documentation of Trading Strategies Fosters a Culture of Compliance*

In the White Papers on Compliance and Enforcement, FERC staff recommends documenting transactions and strategies. As explained by the staff, "[d]ocumenting trading strategies helps compliance understand the traders' activities and provides an easy reference for conducting a review of the organization's trading activities."[7] Perhaps revealing the level of skepticism FERC staff has of trader testimony, the FERC Compliance White Paper included a footnote cautioning that "[c]ompliance personnel should be diligent in checking the accuracy of such documentation to ensure that traders cannot hide misbehavior behind misleading explanations of their trading strategies."[8] In our experience, traders nearly always want to do the right thing and are open and honest in their descriptions, but staff is at least correct that it is crucial to get the facts right.

Staff additionally stressed the particular importance of documenting transactions and strategies involving related physical and financial positions.[9] Many FERC investigations involve allegations of manipulating the price of physical products to benefit financial positions. Staff explained that "[o]ne way to discourage traders from using physical energy products to benefit financial positions is to require documentation of all trading strategies that involve trading related physical and financial products."[10] This documentation, staff recommends, should "explain the rationale for the strategy (*e.g.*, a hedge) and describe the circumstances under which the strategy might be used."[11]

As we noted above, market participants often have difficulty convincing an agency staff zealously pursuing an investigation of the trader's legitimate intent. For this reason, aside from recommending that market participants document strategies and transactions generally, staff also stressed the importance of documenting strategies and transactions to create a contemporaneous record of intent. Staff advised:

> Given the Commission's guidance that purpose is a critical factor in determining fraudulent behavior, entities should consider requiring employees to document and articulate the purpose behind any conduct that is likely to raise red flags so that compliance departments can vet the conduct and ensure that employees have a legitimate reason for it.[12]

In addition to the guidance specifically calling for documentation of transactions and strategies, there are a number of ways that analyzing and documenting transactions and strategies would foster a culture of compliance consistent with regulatory guidance. This is important. Under FERC's Penalty Guidelines, "[f]or an organization's compliance program to be deemed effective . . . an organization must . . . promote an organizational culture that encourages a commitment to compliance with the law."[13]

Analyzing and documenting strategies and transactions fosters a culture of compliance in a number of tangible ways consistent with regulatory guidance. It helps to integrate compliance personnel into the company's business units.[14] It offers compliance and legal personnel the opportunity to provide *ad hoc*, topic-specific training.[15] And it creates a record of a truly engaged compliance function, showing that the company is not relying on a paper program.[16]

In addition, FERC Staff also recommends that companies "[r]equire approval for new products and locations."[17] In support of this recommendation, staff explained that "[r]equiring traders to obtain approval from compliance, their managers, or both, before trading new products or at new locations provides compliance and the business unit managers with an opportunity to vet the traders' new trading strategies and determine whether they would provide an opportunity to engage in misconduct."[18] Staff added that "[a]s part of this approval process, it may also be helpful to require the traders to describe their purpose for trading the new products to assist in determining whether approval is appropriate."[19]

In addition to these benefits, and the corresponding benefit of preventing potentially problematic transactions or strategies before they happen, analyzing and documenting strategies and transactions also can make it more difficult for a regulator to prove fraudulent intent.

B. *Analyzing and Documenting Transactions and Strategies Provides a Defense Against Claims That a Trader's Intent Was Improper*

The most significant areas of regulatory exposure relating to transactions and strategies are the various species of fraud and manipulation claims available to FERC and the CFTC. They include fraud-based manipulation, price manipulation, attempted manipulation, and misappropriation, among others. Each requires the government to prove intent to defraud or manipulate (or, more precisely, *scienter*), and proving a violation often turns primarily on the intent element.[20]

For some claims, a regulator need only establish recklessness while others require knowing intent. For example, within the context of fraud-based manipulation, FERC defines recklessness as "an extreme departure from the standards of ordinary care . . . which presents a danger . . . that is either known to the [actor] or is so obvious that the actor must have been aware of it."[21] Similarly, the CFTC defines recklessness as "an act or omission that 'departs from the standards of ordinary care [to an extent] that it is very difficult to believe the actor was not aware of what he or she was doing.' "[22] By contrast, proving knowing intent in a fraud-based manipulation claim requires a showing that the market participant purposefully designed its conduct to deceive or defraud another person or the market.[23]

Analyzing and documenting a strategy or transaction and why it is lawful in the view of a company's legal or compliance team makes proving wrongful intent extremely difficult for a regulator. Executing a transaction or strategy in reliance on compliance or legal advice based upon an analysis that concluded the transaction or strategy is lawful is not "an extreme departure from the standards of ordinary care." Recklessness would therefore be very difficult to prove.

Without recklessness, a regulator must prove the more-difficult-to-establish specific intent. "Smoking gun" evidence, such as admissions in e-mails, instant messages, or voice recordings, is less likely to exist in a scenario involving documentation of the transaction or strategy. As a result, proving specific intent to defraud or manipulate also would be quite difficult. All other things being equal, the harder a case is to prove, the more likely an investigation is to close, or the easier it is to settle.

C. *Documenting a Proposed Transaction or Trading Strategy in Advance Provides Evidence of Good Faith Conduct*

Analyzing and documenting a transaction or strategy in advance provides strong evidence of good faith, which can negate an inference of fraudulent intent.[24] Separate from an advice of counsel defense, good faith reliance on non-legal experts, appropriate procedures and best practices also should negate the requisite intent for a claim of manipulation.[25]

Courts generally have recognized the following elements of an advice of counsel defense: (i) complete disclosure to counsel of the intended action; (ii) request for counsel's advice on the legality of the intended action; (iii) receipt of counsel's advice that the conduct would be legal; (iv) reliance in good faith on counsel's advice; and (v) the counsel consulted must be disinterested and independent.[26]

There are circumstances in which it is desirable to draft the documentation in order to set up the advice of counsel defense, but we have found that it is often more commercially practical to think in terms of documenting good faith. This approach is easier to implement, consistent with the requirements of the advice of counsel defense, and evidences good intent. Having laid out the reasons to document, we next propose an analytical framework for determining which strategies and transactions to analyze and consider documenting.

II. Framework for Reviewing and Analyzing Proposed Transactions or Trading Strategies

To conduct a thorough, commercially viable, and useful review, companies should develop a flexible process that varies depending upon the facts and circumstances underlying a proposed transaction or strategy. The process should include:

- Identifying the types of transactions and trading strategies, a few examples of which are discussed further below, that will be subjected to this type of review;
- Determining who the right personnel are to conduct the review;
- Conducting the review by identifying all material facts and applicable legal precedent;
- Determining whether, and if so, how, to document the transaction or trading strategy, the review, and if applicable, the approval; and
- Determine whether, and if so, how to monitor the execution of the approved trading strategy or transaction.

Below we provide further guidance and recommended best practices for each of these steps. Absent unusual circumstances, this framework should be applied on a going-forward basis. However, it is plausible to engage in a similar review for a transaction or trading strategy that already has been executed or is continuing. The same guiding principles also should apply then.

A. *Identify Transactions and Strategies That Call for Heightened Internal Scrutiny*

The types of transactions and strategies that trigger heightened regulatory scrutiny are the ones that should trigger heightened internal scrutiny. In the following sections, we categorize and discuss transactions and strategies with significant regulatory risk that companies also should identify internally for additional review and analysis.

1. Transactions and Strategies Involving Related Positions

Transactions involving related positions pose significant regulatory risk. Between FERC and the CFTC, the industry has seen numerous cases and settlements involving cross-product market manipulation claims.[27] The most common related position scenario involves a physical position that is part of price formation of an index against which a financial position settles. For example, in Total Gas and Power North America, Inc.'s ("**TGPNA**") settlement with the CFTC, the CFTC alleged that TGPNA attempted to manipulate monthly index settlement prices of natural gas through its physical fixed-price trading during bid-week.[28] In addition to the CFTC matter, FERC issued an Order to Show Cause against TGPNA, jointly and severally with its affiliates Total S.A. and Total Gas & Power, Ltd., and two traders based upon essentially the same conduct seeking more than $225 million in civil penalties and disgorgement.[29]

Financially settled positions can affect other financial positions as well. FERC settled this sort of claim with Louis Dreyfus Energy Services L.P. in 2014.[30] In organized wholesale electricity markets, "virtual" transactions can be used to affect the value of financial transmission right ("**FTR**") positions.[31] Virtual energy products are traded as hedges or speculatively in wholesale electricity markets to arbitrage the price difference between day-ahead and real-time prices. FTRs arbitrage the day-ahead price difference between two locations. Because virtual trades can affect day-ahead prices and FTRs settle based upon day-ahead prices, virtual trades can affect the value of FTRs.

While it is not expressly prohibited to engage in transactions that involve related, or potentially related positions, doing so with fraudulent or manipulative intent is prohibited and will subject companies and individuals to significant regulatory risk. Therefore, companies should consider instituting policies that would require compliance and/or legal review and approval of transactions and trading strategies that involve related positions. Such a review could be tailored to the specific proposed transaction or trading strategy (*e.g.*, whether it is a one-time trade or an ongoing trading strategy).

2. Transactions and Strategies that Will be Implemented Repeatedly or Over Extended Periods

Transactions and strategies that occur over long periods of time are more likely to come to the attention of regulators simply because of the sheer volume of transactions. FERC and the CFTC have penalty authority to sanction what they conclude is manipulative or attempted manipulative conduct at more than $1 million dollars per violation as defined in their respective statutes.[32] Consequently, strategies or transactions that occur repeatedly over extended periods, if deemed manipulative, can quickly result in exposure to significant civil penalties. Moreover, from a cost-benefit standpoint, a compliance and/or legal review for repeated transactions and strategies will potentially minimize regulatory risks for a larger number of transactions and likely will be well worth the effort.

3. Trading Strategies Based Upon Information that May or May Not Be Proprietary to Your Company

Traditionally, with limited exceptions, insider trading was a permissible practice in commodities and derivatives markets. Prior to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**"), the Commodity Exchange Act ("**CEA**") prohibited only limited types of insider trading activities.[33] The Dodd-Frank Act amended the CEA by including a fraud-based anti-manipulation provision that is modeled on the SEC Rule 10b-5. Pursuant to this revised statutory authority, the CFTC promulgated Rule 180.1 and noted that a misappropriation claim could be brought when someone trades on material non-public information that was lawfully obtained, but used in a way that breaches a pre-existing duty.[34] The CFTC further clarified that the pre-existing duty could be established by another law or rule, understanding or some other source.[35]

Without much further guidance, the CFTC's misappropriation-based theory of manipulation raises significant compliance questions for companies. For example, what types of activities might be implicated (*e.g.*, front-running in OTC derivatives or physical commodities, pre-hedging anticipated transactions, trading to trigger resting orders, and voice brokers that provide market information to a customer). Or, what types of relationships trigger a "pre-existing duty" that might be breached (*e.g.*, swap dealers and customers, voice brokers and customers, aggregator or originator and customer, pipeline operator and customer, storage operator and customer, cooperative and its members, and asset managers). The significant implications of engaging in "insider trading" under the CEA coupled with the lack of clarity on the types of activities that might constitute insider trading counsel careful legal and compliance review and analysis of these activities.

4. Structured Transactions and Trading Strategies Involving one or More RTOs and ISOs

The FERC and, to a lesser extent, the CFTC surveil electricity-based transactions on futures exchanges and in regional transmission organizations ("**RTOs**") and independent system operators ("**ISOs**"). Strategies involving physical and financial transactions between RTOs and ISOs can trigger enhanced regulatory scrutiny for a variety of reasons.[36] In addition, these strategies generally involve multiple physical and financial components, triggering regulatory scrutiny as cross-product transactions.

5. Transactions or Strategies that Could be Viewed by a Regulator as Inconsistent with Market Design

Any strategy or transaction that involves what FERC calls "out of market" payments from an RTO or ISO creates regulatory risk. Therefore, companies should consider reviewing and analyzing any transaction or strategy that is driven by out of market payments or that seeks to optimize out of market payments. GDF Suez Energy Marketing NA, Inc. ("**GSEMNA**") recently agreed to pay $82 million to settle allegations by FERC that GSEMNA improperly targeted and increased its receipt of Lost Opportunity Cost payments in the PJM Interconnection, L.L.C. market.[37] Although the alleged scheme in that case involved payments to a generator, but out of market payments are not limited to generators. Speculative traders also must exercise caution with respect to such payments. The most notable example is the series of "up-to-congestion" cases, many of which are now being litigated in federal court.[38] Each case involves variations of strategies allegedly designed to capture out of market Marginal Surplus Allocation Payments in contravention of the alleged "purpose" of those payments.[39]

6. Trading Practices that Might be Deemed Disruptive

The Dodd-Frank Act also amended the CEA to prohibit three specific types of "disruptive trading practices": (1) violating bids or offers; (2) intentional or reckless trading during the close; and (3) spoofing. Two of the primary commodity exchanges, the CME Group Inc. and the Intercontinental Exchange, have revised their rules to expressly prohibit these types of trading practices.[40] Under the CEA, any of these practices could be the basis for a manipulation claim.

Cases involving violations of bids and offers (*i.e.*, bidding at a price higher than the prevailing offer or offering at a price lower than the prevailing bid) are not, for obvious reasons, the types of trades that companies should review, analyze and document in advance. For one, these violations require no proof of intent so documentation of intent likely would be irrelevant here. Second, companies could institute risk control measures that would detect and prevent these types of trades.

On the other hand, recent CFTC actions have highlighted an enforcement focus on "spoofing" cases, which involve bidding or offering with the intent to cancel the bid or offer before final execution.[41] Companies should analyze any transaction or trading strategy that might involve bids and offers, based on which the traders do not intend to transact. In addition, companies could benefit greatly from reviewing trading patterns or behaviors during the closing period that might be deemed disruptive. These include executing a large volume during the time when the settlement price, index price, or price assessment is calculated or taking a position in the physical commodity that constitutes a large percentage of available supply at a particular location. These types of activities often are scrutinized as part of routine market surveillance.

7. Other Regulatory Analyses

While companies should invest the time and resources to determine which types of transactions and strategies might require additional review and analysis in the context of market manipulation and fraud theories of liability, other regulatory concerns also warrant compliance or legal review and analysis of certain transactions. For example, how a transaction is characterized could implicate significant regulatory requirements and companies might need to establish a legal and compliance framework for the process by which that characterization occurs.

With the passage of the Dodd-Frank Act, the derivatives industry has invested renewed and substantial resources in determining whether certain transactions are spots, forwards, swaps, or trade options. Moreover, the same transaction might involve different accounting, risk management, and regulatory treatment. Companies should identify a consistent process for reviewing and analyzing the characterization of these transactions. For example, companies could institute a process that requires legal or compliance sign-off on the characterization of all new over-the-counter physical and derivatives transactions. This is especially important for physical transactions that include any type of embedded optionality. Futures trades that are, pursuant to exchange rules, exempt from the competitive execution requirement (*e.g.*, exchange of futures for related position transactions or block trades) entail additional regulatory requirements. Companies could benefit significantly from processes that require occasional review of these types of transactions to ensure that these trades are following internal compliance requirements.

B. *Determine Who Should be Involved in the Regulatory Analysis*

In conducting a compliance or legal review, companies must determine which personnel should be involved in the review or analysis. Specifically, companies should consider the following categories of individuals:

- Business: The review should include the trader, his/her manager, and/or someone in operations;

- Legal: Should the review happen at the direction of legal, which will raise privilege questions? If legal is involved, should the review include internal counsel or external counsel? There are pros and cons to each approach that require consideration. For example, conducting the review in-house might save legal fees while a review by external counsel might seem more independent.

- Others: Should the review be conducted by someone in compliance acting at the direction of legal? Note that evidence of good faith can be based on guidance from compliance alone. Should the review involve relevant personnel such as accounting, credit or risk officers?

C. *Analyze the Strategy or Transaction*

1. Review All Material Facts and Gather More Information as Needed

In reviewing and analyzing proposed transactions or trading strategies, it is crucial that the analysis entail reviewing all material facts. This is especially true if the company wants to be able to rely on an advice of counsel defense.[42] In addition to understanding the basic terms of the transaction and the relevant conditions for the trading strategy, companies should consider the source of the information. For example, if the trader represents that the transaction is based on certain market fundamentals, it could be useful for the reviewer to independently verify those market fundamentals. If the review turns on analyzing intent, it could be beneficial to discuss intent with not only the trader but other individuals involved in the transaction or trading strategy to ensure that everyone is on the same page about the goal of the transaction or strategy. While it is impossible to know every single fact or market condition, the review should be based on knowing and understanding all of the *material* facts and market conditions.

2. Review Relevant Legal Precedent

The facts should be reviewed in light of relevant legal precedent, including the relevant statute and regulations, prior administrative and judicial decisions, interpretative guidance, and agency "speaking" orders accepting settlements. To the extent that there are additional public documents, such as responses to show cause orders, companies should review these additional public documents as well. Often, the settlement orders exclude nuanced facts and circumstances that might appear in the show cause order or the response to the show cause order and that might be relevant to the analysis.

3. Approval and Limitations

In reviewing a transaction or a trading strategy, compliance or legal could determine that the proposed transaction is lawful subject to certain compliance limitations. Alternatively, one could determine that the proposed transaction is lawful, but nevertheless impose certain limitations to take a more conservative approach. Such limitations could include limits on trading locations, prices, volumes, information sharing, and others. To ensure the practicality of these limitations, the business team should often assist legal or compliance in designing any protocols or limitations applicable to the proposed trading or transaction.

Finally, if any such protocols or limitations are imposed, it is imperative that they are followed.

D. *Determine Whether and How to Document*

Once you have analyzed a proposed transaction or strategy, there are three possible outcomes. You either approve it, approve it with limitations or disapprove it. Each course of action can call for documentation in certain circumstances. An approval with limitations should be documented because it may involve a transaction or strategy that approaches a regulatory line that you do not want to cross—hence, the limitations. In this section of the framework, we discuss the benefits of documenting (briefly, because we covered much of this information in section I.C. above), some challenges associated with documenting, and the forms your documentation can take. Ultimately, whether and how to document is a judgment call that must consider and balance commercial practicality with the benefits and challenges of documenting.

1. Benefits of Documenting

In addition to the reasons discussed above—that it is consistent with regulatory guidance, fosters a culture of compliance, can help establish legitimate intent and evidences good faith—documenting a transaction or strategy has other benefits as well. It can serve to satisfy management that the proposed transaction or trading strategy is lawful. It may protect the company against franchise (reputation) risk. It also provides an organized way to satisfy regulatory guidance that recommends companies should require review and approval of new trading strategies and transactions.

2. Challenges Associated With Documenting

While there can be many benefits to documenting transactions and strategies, there are undeniable challenges as well. For example, documenting a proposed transaction or strategy may not be possible in the time provided. Some potential transactions or strategies involve time-sensitive transactions and/or rapidly changing market conditions. Below, we categorize and discuss some of the other challenges to consider.

Facts and circumstances. Often compliance and legal personnel are required to exercise good judgment where the law is not clear and application of the governing rules turns on the facts and circumstances. Documenting such scenarios can be difficult and time consuming, but it can also be especially valuable when the particular facts and circumstances of a scenario are of special importance to the legal analysis.

Waiver. Documenting a transaction or strategy can also create attorney-client privilege and work-product waiver issues. The advice of counsel defense, for example, generally requires waiver of such protections. However, the advice of counsel defense can be difficult to deploy successfully because regulators and courts may require an exacting showing of good faith.

Risk Mitigation. Documenting is not a silver bullet. While having sound documentation of intent would make a prosecutor's job more difficult, it does not guarantee that a regulator with the benefit of twenty-twenty hindsight will not continue to pursue an investigation.

Consistency. Documenting may create difficulty if you do not have a sound methodology that you comply with for documenting some strategies and transactions but not others.

Monitoring. As we discuss in greater detail below in section II.E, choosing to document can also create the need for ongoing execution protocols and compliance monitoring, which, in some circumstances, may be difficult to implement

Whether or not to document must ultimately be assessed on a case-by-case basis. The decision is a judgment call and relies on a realistic consideration of the regulatory risks in light of all applicable law balanced against what works for the business.

3. Determine the Form of Documentation

Related to the question of whether to document is how to document. Documentation can take many forms, but the sort of documentation that this article contemplates is created affirmatively and intentionally. Relying on pre-existing commercial documents created by your company in the ordinary course of the business is likely not sufficient to meet the purposes of documentation discussed herein because they typically do not address regulatory compliance.

How to document also must be assessed on a case-by-case basis. However, the consideration can also be thought of as a sliding scale. In general, the greater the regulatory risk, the more formal and thorough the documentation ought to be. The less regulatory concern there is, the less formal documentation can be. At a certain point, there is little enough regulatory concern that you fall off the scale and do not document.

The assessment of regulatory risk that informs whether and how to document should be considered from multiple perspectives. You should consider not only the transaction or strategy as presented, but also how a regulator might view it with the benefit of twenty-twenty hindsight. Considering the likelihood of being investigated, however, is not enough. You should also consider the scope that such an investigation might take and the financial exposure that the company and trader could face. Franchise risk stemming from regulatory risk also can be extremely important to some companies and should not be ignored.

The form of the document is generally less important than its substance. On the less formal end of the spectrum, an e-mail could suffice in certain circumstances. Where there is greater regulatory risk, a memorandum to file may be advisable. When there is significant regulatory risk, a memorandum prepared by internal or outside counsel may be advisable. In general, however, if you are going to the trouble of documenting your analysis of a strategy or transaction, it is often worth formalizing the document as a memorandum. That way, if it has to be produced, it will provide a complete picture of the facts, analysis and conclusion.

E. *Determine Whether You Need to Implement Ongoing Monitoring*

If you have imposed any compliance-related rules, limits, restrictions or protocols, then it is important to monitor compliance with them. FERC staff has stated that companies should not set "compliance-related rules, limits, and restrictions and then [fail] to monitor for violations or discipline those who violate rules in a meaningful way."[43] Therefore, if a company analyzes and approves a proposed transaction, it should also monitor the execution of the transaction. Monitoring could include, for example, reviewing the profits and losses of a transaction or strategy to make sure that it is accomplishing what it sought to accomplish and, if not, obtaining an explanation for any discrepancy. If the profits and losses are not reflective of what was originally proposed, compliance or legal could either require termination of the transaction or further justification for it. Monitoring also could include reviewing communications related to the proposed transaction to ensure that the facts provided to legal or compliance (*e.g.*, intent) are the same as those being discussed among the traders.

Moreover, if compliance or legal has instituted certain limitations in approving the transaction, it should also monitor compliance with those limitations. If the executed transaction fails to comply with specified protocols or limitations, compliance or legal should analyze next steps, including for example, whether termination is appropriate and feasible.

III. Conclusion and Recommendations

Although how much and how often to document proposed strategies and transactions depends largely on the nature of your business, the foregoing framework is intended to provide some guidance for making that determination. Companies should have policies and procedures that are proportional in scope and detail to the size of their businesses that provide for contemporaneous analysis and, possibly, documentation of proposed trading strategies and transactions that likely could be subject to regulatory scrutiny. Finding a commercially reasonable balance between compliance and legal undertakings and regulatory exposure is generally consistent with regulatory guidance.

ENDNOTES:

[*]The authors thank Paul J. Pantano, Jr., partner at Willkie Farr & Gallagher LLP, for his editorial support and guidance. They also thank Alex Tirrell for her always excellent support.

[1]Notebook entry, January or February 1894, Mark Twain's Notebook, ed. Albert Bigelow Paine (1935), p. 240.

[2]Mark L. Howe & Lauren M. Knott, *The Fallibility of Memory in Judicial Processes: Lessons From the Past and Their Modern Consequences*, (Taylor & Francis Open Select, July 4, 2015), https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4409058/.

[3]Staff White Paper on Effective Energy Trading Compliance Practices at 13 (2016) ("**FERC Compliance White Paper**"), https://www.ferc.gov/legal/staff-reports/2016/tradecompliancewhitepaper.pdf.

[4]*The Commodity Futures Trading Commission: Effective Enforcement and the Future of Derivatives Regulation*, Hearing Before the S. Comm. on Agric., Nutrition and Forestry, 113th Cong. 22 (Dec. 10, 2014) (testimony of Timothy Massad, Former Comm'r, Commodities Futures Trading Commission), https://www.agriculture.senate.gov/imo/media/doc/Testimony_Massad1.pdf.

[5]Kat Greene, *Prison Time Best Antitrust Deterrent, DOJ Enforcer Says*, Law 360 (Nov. 3, 2016), https://www.law360.com/articles/859487/prison-time-best-antitrust-deterrent-doj-enforcer-says.

[6]FERC Compliance White Paper at 13.

[7]*Id.*

[8]*Id.* at 13, n.21.

[9]*Id.* at 13.

[10]*Id.*

[11]*Id.*

[12]Staff White Paper on Anti-Market Manipulation Enforcement Efforts Ten Years After EPACT 2005 at 13 (2016) ("**FERC White Paper on Enforcement**"), https://www.ferc.gov/legal/staff-reports/2016/marketmanipulationwhitepape

r.pdf.

[13]*See* Enforcement of Statutes, Orders, Rules, and Regulations, 132 FERC ¶ 61,216 (2010) ("Revised Policy Statement on Penalty Guidelines").

[14]FERC Compliance White Paper at 7.

[15]*Id.* at 8-9.

[16]*Id.* at 22.

[17]*Id.* at 13.

[18]*Id.*

[19]*Id.*

[20]*See e.g.*, *Prohibition of Energy Mkt. Manipulation*, Order No. 670, FERC Stats. & Regs. ¶ 31,202 at P 49 ("Order No. 670"), *reh'g denied*, Order No. 670-A, 114 FERC ¶ 61,300 (2006); *see also* Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,404 (July 14, 2011).

[21]*New York Indep. Sys. Operator, Inc.*, 128 FERC ¶ 61,049, Order Authorizing Public Disclosure of Enforcement Staff Report (2009), 128 FERC ¶ 61,239, Order Granting Clarification (2009), 132 FERC ¶ 61,031, Order on Compliance (2010), Enforcement Staff Report at 26 (June 10, 2009) (quoting *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992) (other citations omitted)).

[22]Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,404 (July 14, 2011) (quoting *Drexel Burnham Lambert Inc. v. CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1988)).

[23]Order No. 670 at P 52, n.106 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)); *see also Richard Blumenthal, Att'y Gen. for the State of Connecticut v. ISO New England Inc.*, 132 FERC ¶ 63,017, Initial Decision, P 108 (2010).

[24]*See, e.g.*, *United States v. Peterson*, 101 F.3d 375, 381 (5th Cir. 1996) ("A good faith reliance on the advice of counsel is not a defense to securities fraud. It is simply a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud."); *see also Howard v. SEC*, 376 F.3d 1136, 1147 (D.C. Cir. 2004) (citation omitted) ("Reliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter.") Bevis Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 Bus. Law. 1185, 1187 (1982).

[25]Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: W.R. Grace & Co., Release No. 34-39157, 65 SEC Docket 1240-27 (Sept. 30, 1997) (explaining that "[a]n officer or director may rely upon the company's procedures for determining what disclosure is required" as long as "he or she has a reasonable basis for believing those procedures have resulted in a full consideration of those issues"); American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 4.02 (1994) ("In performing his or her duties and functions, a directors or officer who acts in good faith, and reasonably believes that reliance is warranted, is entitled to rely on information, opinions, reports, statements (including financial statements and other financial data), decisions, judgments, and performance . . . prepared, presented, made or performed by . . . employees of the corporation [or] legal counsel.").

[26]*See United States v. West*, 392 F.3d 450, 447 (D.C. Cir. 2004) ("A defendant may avail himself of an advice of counsel defense only where he makes a complete disclosure to counsel, seeks advice as to the legality of the contemplated action, is advised that the action is legal, and relies on that advice in good faith."); *Markowski v. SEC*, 34 F.3d 99, 104-05 (2d Cir. 1994) ("To invoke this principle, Markowski has to show that he made complete disclosure to counsel, sought advice as to the legality of his conduct, received advice that his conduct was legal, and relied on that advice in good faith.").

[27]*U.S. Commodity Futures Trading Commission v. Kraft Foods Group, Inc.*, No. 15-02881, (N.D. Ill Apr. 1, 2015); *In re Deutsche Bank*

Energy Trading, LLC, 142 FERC ¶ 61,056 (2013); *In re Constellation Energy Commodities Group, Inc.*, 138 FERC ¶ 61,168 (2012).

[28]*In re Total Gas & Power North America, Inc. et al.*, CFTC No. 16-03, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Actions, at 2 (Dec. 7, 2015).

[29]*Total Gas & Power North America, Inc. et al.*, 155 FERC ¶ 61,105, Order to Show Cause and Notice of Proposed Penalty (2016).

[30]*MISO Virtual and FTR Trading*, 146 FERC ¶ 61,072 (2014).

[31]FTRs are part of a family of similar products that derive their value from differences in the congestion component of LMPs between a source and a sink. They go by different names in different markets, including Transmission Congestion Rights and Transmission Congestion Contracts.

[32]*See* 7 U.S.C. § 9(10)(c)(ii) (2017); 16 U.S.C. § 825o-1(b).

[33]*See* CEA §§ 4c(3); 9(c) - (d) (prohibiting: (1) federal employees from trading futures or swaps for personal gain based on non-public information that they acquired as a result of their position; (2) CFTC commissioners, employees, and agents from trading futures, swaps, or commodities based on non-public information, or sharing such information with the intent to assist another person in trading; and (3) employees, members of the governing board or a committee of a registered entity (*e.g.*, futures exchanges, SDRs) or a registered futures association from trading futures or swaps or disclosing improperly any material non-public information obtained through special access related to the performance of their duties.).

[34]Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,403 (July 14, 2011).

[35]*Id.*

[36]*See e.g.*, *New York Indep. Sys. Operator, Inc.,* 128 FERC ¶ 61,049 at P 2.

[37]*GDF SUEZ Energy Marketing NA, Inc.*, 158 FERC ¶ 61,102, Order Approving Stipulation and Consent Agreement, P 1 (2017);*see also Maxim Power Corp.*, 156 FERC ¶ 31,223 (2016).

[38]*Federal Energy Regulatory Commission v. Powhatan Energy Fund, LLC*, No. 15 -CV-00452 (E.D. Va. Jul. 31, 2015); *Federal Energy Regulatory Commission v. City Power Marketing, LLC*, No. 15-CV-01428 (D.D.C. Sept. 1, 2015); *Federal Energy Regulatory Commission v. Coaltrain Energy, L.P.*, No. 16-CV-00732 (S.D. Oh. July 27, 2016).

[39]*Federal Energy Regulatory Commission v. Coaltrain Energy, L.P.*, No. 16-00732, Petition for an Order Affirming the Federal Energy Regulatory Commission's May 27, 2016 Order Assessing Civil Penalties Against Coaltrain Energy, L.P., Peter Jones, Shawn Sheehan, Robert Jones, Jeff Miller, and Jack Wells, P 65 (S.D. Oh July 27, 2016).

[40]*See* CME, CBOT, NYMEX & COMEX Market Regulation Advisory Notice, Disruptive Practices Prohibited, CME Group RA1405-5 (Aug. 29, 2014) *available* at http://www.cmegroup.com/tools-information/lookups/advisories/market-regulation/files/RA1405-5.pdf; ICE Futures U.S. Exchange Notice, Disruptive Trading Practices (Dec. 29, 2014) *available at* https://www.theice.com/publicdocs/futures_us/exchange_notices/IFUS_Disruptive_Practices_Notice.pdf.

[41]*See e.g.*, *United States v. Sarao*, No. 15-CR-00075, (N.D. Ill Sept. 2, 2015) (Sarao was indicted (and ultimately pleaded guilty) for spoofing activity in the CME's E-mini S&P 500 futures contract. According to the complaint, Sarao's trading activity created order-book imbalance on several days including May 6, 2010, which contributed to the "flash crash" where the Dow lost approximately 1,000 points and rebounded in a very short time period.); *United States v. Coscia*, No. 14-CR-00551 (N.D. Ill. Oct. 1, 2014) (Coscia engaged in commodities fraud and unlawful spoofing activity by submitting large, layered orders, that Coscia did not intend to execute. Coscia utilized the layered orders to move the bid/ask spread of the market to execute smaller

orders opposite the layered order at beneficial prices.); *U.S. Commodity Futures Trading Comm'n v. Heet Khara and Nasim Salim*, No. 15-CV-03497 (S.D. NY Mar. 31, 2016) (Khara repeatedly entered large "layered" orders for Gold and Silver futures contracts a few ticks away from the best bid or offer that Khara did not intend to trade. Khara placed small-lot orders on the opposite side of the market Khara entered the large layered orders to encourage market participants to trade opposite his smaller resting order. After receiving a fill on his smaller orders, Khara would cancel the resting layered orders. After cancelling the large orders, Khara would perform the same strategy in reverse thereby offsetting his position and gaining a profit from the difference in price achieved by moving the bid/ask spread.)

[42]*Seminole Energy Services, LLC*, 126 FERC ¶ 61,041 (2009), Enforcement Staff Report and Recommendation at 32 ("First, Seminole did not 'make a complete disclosure to the attorney of the intended action.' In the e-mails, there is no mention of the structuring (*i.e.*, buy-sells) or the purpose (*i.e.*, defeat *pro rata*) of the multiple-affiliate bids. For all counsel knew at that time, Seminole could have had a legitimate business purpose for each bid."); *Dolphin and Bradbury, Inc. v. SEC*, 512 F.3d 634, 642 (D.C. Cir. 2008) (failure to disclose information to attorney "substantially undercuts" reliance of counsel defense); *In re Commodities Int'l Corp.*, CFTC No. 83-43, Comm. Fut. L. Rep. (CCH) ¶ 25,672 (Apr. 9, 1993) ("A threshold requirement of a good faith defense based upon reliance upon an attorney's advice is that the party must first be forthright with the attorney. Essential is the demonstration that counsel was fully informed as to all relevant facts.") (citing *SEC v. Savoy Industries, Inc.*, 665 F.2d 1310, 1315 (D.C. Cir. 1981)).

[43]FERC Compliance White Paper at 22.

