**UNITED STATES OF AMERICA**
**FEDERAL ENERGY REGULATORY COMMISSION**

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| Coaltrain Energy, L.P., Peter Jones, Shawn Sheehan, Robert Jones, Jeff Miller, Jack Wells, and Adam Hughes | Docket No. IN16-4-000 |

**Reply of Enforcement Staff to Answers Submitted by Coaltrain Energy, L.P., Peter Jones, Shawn Sheehan, Robert Jones, Jack Wells, Jeff Miller, and Adam Hughes**

The Staff Report details how Coaltrain Energy, L.P. (Coaltrain), Peter Jones, Shawn Sheehan, Robert Jones, Jack Wells, Jeff Miller, and Adam Hughes (collectively, Respondents) violated the Anti-Manipulation Rule by placing Up-To Congestion (UTC) trades pursuant to what they called the "OCL Strategy"—"OCL" standing for Over-Collected Losses, which is how Respondents referred to the Marginal Loss Surplus Allocation (MLSA) payments at the heart of this case. These trades falsely appeared to arbitrage price differentials but in fact were designed not to profit from spread changes but to minimize them to obtain MLSA payments that otherwise would have gone to other market participants who did legitimate transactions. And Respondents succeeded, diverting about $8 million in improper MLSA payments for their OCL Strategy trades over a span of about ten weeks, and netting about $4 million in unjust profits.

The Staff Report also details how Coaltrain violated the Commission's rule requiring candor in communications, 18 C.F.R. § 35.41(b) (2015), by making numerous false and misleading statements and material omissions in their communications with staff of the Commission's Office of Enforcement (Enforcement) and with PJM's Independent Market Monitor (IMM). Among these statements and omissions are: Coaltrain's failure to produce (or even apprise Enforcement of the existence of) hundreds of thousands of responsive documents recorded by the company's computer security monitoring software; the sworn statements by Peter Jones (one of Coaltrain's co-owners) that the incomplete responses were true, accurate, and complete; and Coaltrain's misleading communications to the IMM in July and August 2010 in which it falsely

promised to stop making trades aimed at MLSA after the IMM warned that trading to do so was illegitimate.

On March 4, 2016, after receiving a 28-day extension, Respondents submitted three Answers to the Order to Show Cause containing more than 170 pages of legal argument and attaching approximately 250 more pages of fact argument, including a new report by their consultant, Dr. Jonathan Lesser (Lesser), sworn declarations by each of the individual respondents as well as by Gary Wrinn (a former Coaltrain IT employee who is now employed by Peter Jones's new interrelated companies), and a list of what they say are 375 material facts in dispute. Despite the rhetoric deployed throughout their lengthy submissions, the Respondents do not credibly rebut the factual and legal conclusions in the Staff Report.

As an initial matter, it is important to consider what is *not* in dispute here. For the manipulation violation, Respondents do not deny in their Answers that they made the trades listed in the Staff Report.[1] They do not dispute that overall, their OCL trades (unlike their legitimate spread trades) lost money but for MLSA payments. They do not deny that when they said "OCL" they meant "Over-Collected Losses," *i.e.* MLSA. They do not dispute that the names they themselves gave to the two UTC trading strategies they employed in the summer of 2010 were the "Spread Strategy" and the "OCL Strategy." They concede that they "considered" MLSA payments in planning and placing their OCL Strategy trades. They do not dispute that the paths listed in the Staff Report were ones on which they made trades pursuant to the OCL Strategy. They do not dispute that SouthImp-Exp and NCMPAImp-Exp were OCL Strategy trades. They do not deny that they made other OCL Strategy trades after they were asked to stop trading SouthImp-Exp and NCMPAImp-Exp. They do not dispute that they elected to increase their transaction costs on their OCL trades by paying to reserve transmission on those

[1] Some of the items discussed herein are included in Respondents' list of "material facts in dispute," but that is merely a list of facts that they baldly "deny" without any substantiation. Simply using the word "deny" without any supporting discussion is not enough to raise a genuine dispute.

paths even though they knew how to avoid doing so, nor do they deny knowing that MLSA was at that time distributed only for trades using paid-for transmission. Furthermore, although they claim they should not be assessed any penalties or disgorgement, Respondents do not meaningfully dispute the Staff Report's estimate of unjust profits or the Penalty Guidelines calculation.

Similarly, Coaltrain concedes the central facts about its section 35.41(b) violations. Coaltrain does not deny that it used computer security monitoring software called Spector 360, and that this software recorded nearly everything done on employees' home and office computers during the time in question. Coaltrain does not dispute that Spector 360 recorded documents responsive to Enforcement's Second Data Request in 2010. Coaltrain does not dispute that although it was asked to produce all responsive documents, it failed to search the Spector 360 records or produce any materials from Spector 360 until specifically requested to do so in mid-2012. Coaltrain also does not contend that its response to the First Data Request was true, accurate, and complete. It does not deny that the company actually reviewed the Spector 360 records in early July 2012, weeks *before* telling Enforcement that it couldn't access those same records. And it does not dispute that it promised the IMM that it would not make trades aimed at MLSA payments, and then for weeks did make such trades.

Throughout the Answers, there are basic tensions in Respondents' arguments that they fail to resolve. For instance, on the one hand, they claim that the trades at issue in this proceeding were done for the purpose of profiting from positive spreads (a claim that is not supported by the trade data), but on the other they say they considered MLSA payments in determining which trades to make. They claim they considered MLSA in making their trades, but then say they couldn't estimate in advance how large those MLSA payments might be. Similarly, they state that the OCL Strategy trades were (a) risky and volatile *but also* (b) a "low risk/reward" strategy. They complain that Enforcement is prosecuting them for "thought crime," but they ignore that the elements of manipulation include scienter *and* conduct, and that the Staff Report is replete with proof of both.

As to its violations of section 35.41(b), Coaltrain contends that Enforcement had actual knowledge of its Spector 360 records before the investigation began—and suggests that although Enforcement asked for *all* responsive documents, it is Enforcement's fault that Coaltrain failed to produce Spector 360 documents. They also claim that this case is about a simple "discovery dispute," ignoring that real discovery disputes arise when a party objects to producing materials that the party admits it has, not when a party fails to disclose the existence of the materials in question.

As this reply will show, the Respondents fail to rebut the findings and conclusions in the Staff Report. This proceeding is about trades Respondents made to collect MLSA payments instead of profitably arbitraging price spreads, and about their false and misleading statements and material omissions made before and during the investigation. And the credible evidence is overwhelming. It is not a case, as they would have it, about whether there is some specific quantum of risk that *per se* exonerates them for their OCL Strategy trades. Nor do Respondents' novel legal theories about section 35.41(b) help them. Contrary to their new contention, and as settled precedent shows, false and misleading statements and material omissions (absent due diligence) violate section 35.41(b) without regard to their effect on the audience. As Commission precedents also show, the hiring of outside counsel does not satisfy the due diligence standard of section 35.41(b), particularly when the violation involves matters about which the company itself is intimately familiar. Nor is Coaltrain correct in claiming that (a) the Commission cannot pursue section 35.41(b) violations when manipulation is involved, (b) section 35.41(b) does not apply to false and misleading statements and material omissions in investigations, or (c) that there is a scienter element in section 35.41(b).

Finally, Respondents are wrong in contending that the Commission lacks authority to conduct this Order to Show Cause proceeding, and wrong in contending that, even though they declined the opportunity to have a hearing before an ALJ, the Commission is powerless to resolve factual disputes—and therefore effectively powerless to determine whether a violation occurred—using the procedure that Respondents elected. These meritless procedural arguments are designed to distract from the straightforward factual

and legal case against them: (a) overwhelming evidence from Respondents' own files and testimony shows that (b) they performed trades functionally identical to ones the Commission has condemned in *Chen*[2] and *City Power*,[3] and (c) that they made false and misleading statements and material omissions of the kind the Commission has repeatedly found to violate section 35.41(b).

This reply consists of four parts. First, the reply will address Respondents' attempt to challenge the allegations that their OCL Strategy trades manipulated the market. Next, the reply will address their answer to the allegations that they violated section 35.41(b) of the Commission's regulations by providing false and misleading statements and material omissions to Enforcement and to the IMM. Third, the reply will respond to their concerns about the Commission's authority to issue the remedies sought in the Staff Report. Finally, the reply will address the challenges they make to the Commission's procedures.

## I. Manipulation Violation

Respondents make a number of legal and factual arguments concerning the allegations in the Staff Report that they manipulated the market. None successfully rebuts the Staff Report's allegations or alters the conclusion that they violated the Commission's Anti-Manipulation Rule. The first section below addresses their allegations that the Staff Report is wrong on the facts. The second addresses the substance of their legal and factual arguments concerning market manipulation.

### A. Respondents' Contentions About Facts Alleged in the Staff Report Pertaining to Market Manipulation are Without Merit

Respondents make a number of contentions that the facts alleged in the Staff Report are wrong. These claims miss the mark, and none has material significance to this matter.

#### 1. The Staff Report's List of OCL Trades Was Derived From Respondents' Own List of OCL Paths

[2] *Houlian Chen*, 151 FERC ¶ 61,179 (2015) (*Chen*).

[3] *City Power Marketing, LLC*, 152 FERC ¶ 61,012 (2015) (*City Power*).

Respondents claim (Coaltrain Answer at 46, (hereinafter "Ans.")) that the Staff Report's list of OCL trades includes trades that Respondents had not tagged with the "OCL Strategy" label. In fact, the Staff Report is based on the list of OCL trades that Coaltrain itself created. As the Staff Report explains (Report at 3 n.8), staff's list of actionable OCL trades was modified slightly to *exclude* trades that were not eligible for MLSA (*i.e.* false positives) and *include* MLSA-eligible trades made during the Relevant Period that were made on *paths* that Coaltrain had identified as "OCL," but which were themselves not specifically designated as "OCL" (*i.e.* false negatives).

While Enforcement believes that the false negatives at issue here were in fact manipulative trades that were just wrongly tagged, the impact of simply removing the false negatives from the list is only *de minimis*. The Staff Report recited the following numbers for the OCL trades: 4,649,891 MWh of cleared OCL trades, collecting $8,053,066 in MLSA payments, netting unjust profits in the amount of $4,121,894.[4] The false negatives amounted to only 46,459 MWh of cleared trades on 4 paths for which they collected $64,239 in MLSA payments, and received unjust profits of $31,211, as the following table of the "false negative" trades shows:[5]

| **False Negatives** | | Time Period | | | UTC Profits and Losses | | | | | UTC Volumes | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Source Pnode | Sink Pnode | First Date | Last Date | Number of Days | UTC Revenues ($) | OASIS & EES Charges ($) | PnL (w/o MLSA) ($) | MLSA ($) | Total PnL ($) | MLSA-Eligible (MW/h) | UTC Cleared Volume (MW/h) |
| BEAV DUQ UNIT1 | MICHFE | 02Jul2010 | 05Aug2010 | 4 | 5,162 | (12,287) | (7,125) | 33,652 | 26,527 | 19,798 | 28,159 |
| CPLEIMP | DUKEXP | 18Jun2010 | 18Jun2010 | 1 | (1,516) | (973) | (2,489) | 1,699 | (790) | 1,100 | 1,100 |
| MISO | AK STEEL | 20Jun2010 | 20Jun2010 | 1 | (13,593) | (2,518) | (16,111) | 14,785 | (1,326) | 8,800 | 8,800 |
| SOUTHIMP | SOUTHEXP | 05Jul2010 | 05Jul2010 | 1 | 0 | (7,302) | (7,302) | 14,102 | 6,800 | 8,400 | 8,400 |
| | | | | | | | | | | | |
| **TOTAL** | | | | | (9,947) | (23,080) | (33,027) | 64,239 | 31,211 | 38,098 | 46,459 |

These amounts are immaterial: about 1% of the OCL trading volume listed in the Staff Report, about 0.79% of the MLSA payments, and about 0.75% of the unjust profits.

Coaltrain's list of trades that they had tagged with the OCL Strategy label also included a handful of trades that did not use paid transmission. Because those trades were ineligible for MLSA payments, the Staff Report did not include them in the list of OCL trades. *See* Staff Report at 34. Nevertheless, since the Respondents complain that

[4] Report at 3.

[5] This information is derived from all data cited in the Staff Report at 3 n.8.

the Staff Report's list has some variation with Coaltrain's own list, the following table shows these "false positives" that were excluded from the list of trades at issue in this proceeding (and also shows that the numbers were not material):[6]

| **False Positives** | | Time Period | | | UTC Profits and Losses | | | | | UTC Volumes | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Source Pnode | Sink Pnode | First Date | Last Date | Number of Days | UTC Revenues ($) | OASIS & EES Charges ($) | PnL (w/o MLSA) ($) | MLSA ($) | Total PnL ($) | MLSA-Eligible (MW/h) | UTC Cleared Volume (MW/h) |
| EAST BEND 2 | SOUTHWEST | 20Jun2010 | 20Jun2010 | 1 | (18,323) | (1,468) | (19,791) | 0 | (19,791) | 0 | 11,000 |
| NCMPAIMP | NCMPAEXP | 03Jul2010 | 04Jul2010 | 2 | (172) | (478) | (650) | 0 | (650) | 0 | 2,400 |
| ROCKPORT | MISO | 19Jun2010 | 19Jun2010 | 1 | 6,548 | (1,890) | 4,658 | 0 | 4,658 | 0 | 8,800 |
| ROCKPORT | SOUTHWEST | 16Jun2010 | 16Jun2010 | 1 | (5,240) | (2,062) | (7,302) | 0 | (7,302) | 0 | 9,600 |
| | | | | | | | | | | | |
| **TOTAL** | | | | | (17,186) | (5,898) | (23,084) | 0 | (23,084) | 0 | 31,800 |

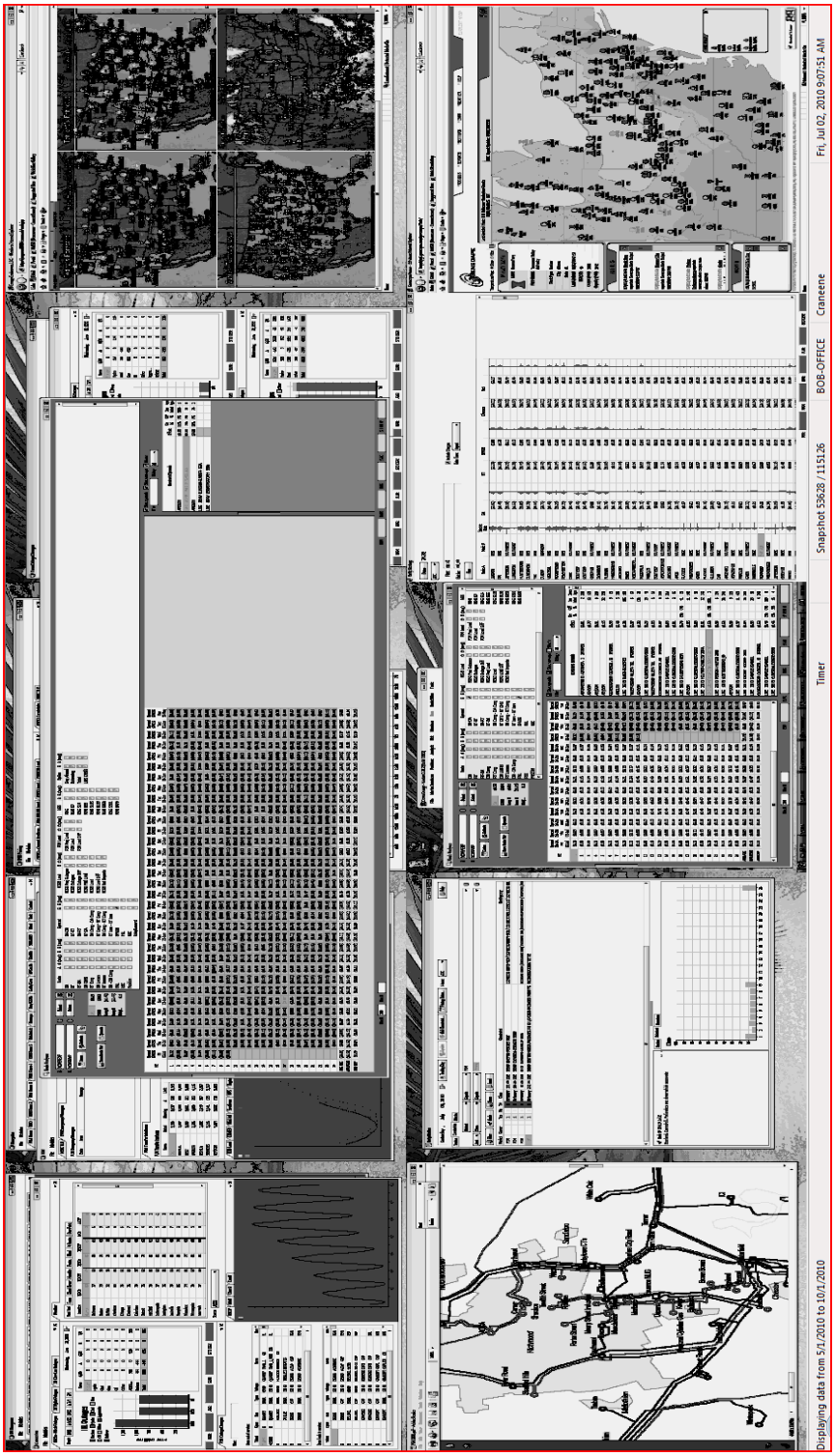
In sum, if the "false negative" trades are removed from the list of OCL trades at issue in this proceeding (and if the false positives remain excluded), the result is: 4,603,432 MWh of OCL trades, generating $7,988,828 in MLSA payments, for a total unjust profit of $4,090,682.

### 2. <u>The Screenshots Identified in The Staff Report Accurately Depicted The Spector 360 Information</u>

Respondents complain (Ans. at 39-40, 48-50) that the Staff Report failed to include certain screenshots, and that a handful of the screenshots included in the Staff Report were cropped in a way that left out important information. As to the latter point, *all* of the screenshots in the Staff Report were cropped, as are all of the screenshots in Respondents' Answers, and for good reason: most of the images captured by Spector 360 included the contents of six or more monitors at the same time, making uncropped images unreadable. For example, here is the uncropped screenshot of Robert Jones's

[6] The Respondents also made two days' of SouthImp-Exp trades in mid-June that did not use paid transmission, and therefore were also ineligible for MLSA. Because the Respondents did not tag those trades with the OCL label, and because those trades were not part of the scheme because transmission was not paid for, those specific trades have never been part of this proceeding. However, as related in the Staff Report (at 46), when asked about why it did not use paid transmission for those trades, Coaltrain responded that "we believe this was a mistake and we did intend to pay demand charges for these reservations." Coaltrain Resp. to Enforcement Fourth Data Request, Question 10 (Jul. 3, 2012).

monitors on July 2, 2010 at 9:07 a.m. (the same image they excerpt at 39):[7]




[7] R. Jones Screenshot 53628 (Jul. 2, 2010 9:07:51 a.m.).

But Enforcement provided *all* of the Spector 360 screenshots, in their entirety, in the investigative materials submitted in this proceeding for the Commission's use.

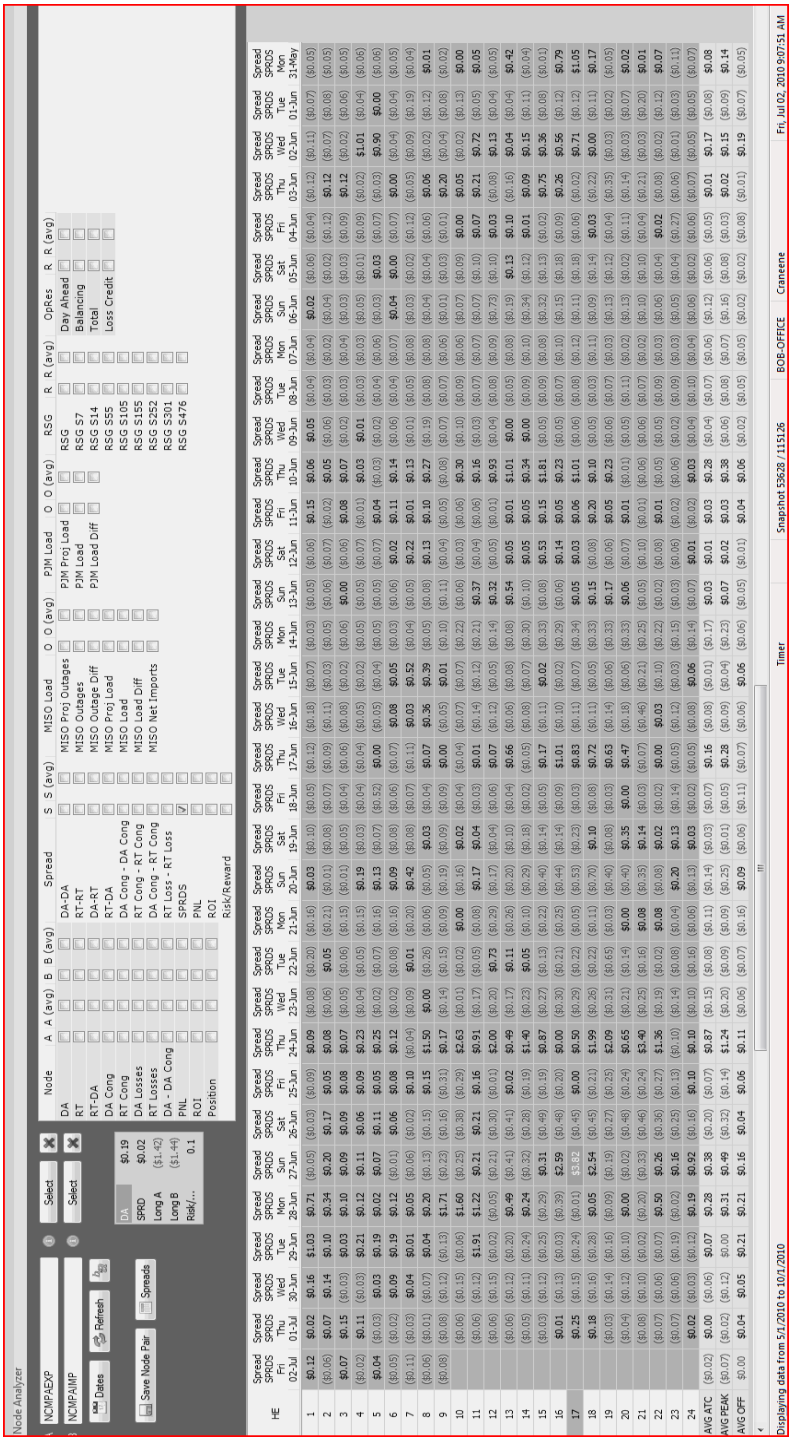
As to Respondents' claims about specific screenshots, the additional material identified by Respondents does not meaningfully help them. For example, Respondents state (Ans. at 39-40) that the Node Analyzer tool sometimes included a list of constraint effects, and specifically point to a screenshot of Robert Jones examining NCMPAImp-Exp on July 2, 2010.[8] But that does not help Respondents. First, the Staff Report does not allege that the Respondents never did any fundamentals research before making their OCL trades. Indeed, some research was necessary to identify attractive paths for the OCL Strategy. In any event, the constraint that Robert Jones highlighted in that screenshot was known as Cloverdale-Lexington. Yet when Jones wrote to his colleagues that same morning to propose trading NCMPAImp-Exp trade as "a meg tester for a high load/high loss credit day," he specifically said it was "not for Clov Lex."[9] That is, the constraint that Coaltrain now focuses on to explain why Jones placed the NCMPAImp-Exp trade was *not* why Jones placed the trade at the time.

Finally, the fact that NCMPAImp-Exp had occasional positive (and negative) spreads in the Real-Time (as the Staff Report noted) does not contradict the fact that it was an OCL path—as the Staff Report indicated (at 33), the path from time to time experienced tiny positive (and negative) spreads. But, as the following screenshot (another portion of the screenshot dated July 2, 2010 at 9:07:51 a.m.) indicates, Jones saw that going back to late May, NCMPAImp-Exp had mostly experienced negative spreads, and only rarely was the positive spread large enough to pay for transaction costs (that is,

[8] Respondents cite the correct screenshot number—53628—but provide the wrong time. The correct time of the July 2, 2010 screenshot depicted on page 39 of the Answer is 9:07:51 a.m.

[9] Ex. CT-RJ 126. Jones made his comment at 9:07 a.m. on July 2, 2010, though the screenshot in this exhibit was captured at 11:25:03 a.m.

the light grey numbers in this excerpt are negative):[10]




In short, what Jones saw when he first looked into the NCMPAImp-Exp path was just what the respondents in *City Power* saw: a UTC path whose fundamentals made it

[10] R. Jones Snapshot 53628 (Jul. 2, 2010 9:07:51 a.m.) (excerpt).

unattractive for large-volume trading to arbitrage price spreads, particularly if the trader voluntarily increased costs by choosing to pay for transmission. As discussed below, as in *City Power*, the question is not whether NCMPAImp-Exp happened to have small positive spreads during this period (albeit far too little to pay for transaction costs), but whether the Respondents traded the path intending to collect spreads or MLSA. Because they put on NCMPAImp-Exp trades involving huge volumes for 10 or more hours every day; because the path's history clearly indicated that one could not profit from positive spreads when trading in that manner; because they called it an "OCL" trade (in contrast to a "Spread" strategy trade); because they markedly increased the NCMPAImp-Exp volumes when they were directed to stop trading SouthImp-Exp in late July; because they placed their NCMPAImp-Exp trades almost exclusively in the period HE 10-22 when load and MLSA payments were highest; and because they voluntarily paid for transmission,[11] the evidence demonstrates that Respondents made their NCMPAImp-Exp trades to collect MLSA, not spreads.

Respondents also contend (Ans. at 48-49) that adding the "constraints" section to the screenshot exhibited in Exhibit CT-RJ 14 shows that Robert Jones saw that the Miami Fort 7/East Bend 2 combination trade (two points near the Ohio River separated by about 25 miles) had experienced significant price divergences at HE6, and that the path was materially affected by a constraint. But, again, Enforcement has not alleged that any of the OCL paths had perfectly *zero* Day-Ahead and Real-Time spreads throughout time (in fact the Staff Report expressly stated that they sometimes made or lost money on particular trades, and that the only "perfect" OCL Strategy trade that summer was SouthImp-Exp). Instead, the evidence shows that Respondents made trades on the OCL paths at times and in volumes that prove that they did not make those trades in an attempt to profit from the fundamentals. Thus it is not surprising that the Miami-East Bend combination trade experienced periodic spreads, or that it might be affected by certain constraints from time to time. But *Respondents' actual trading does not reflect an*

[11] As the Staff Report indicates, the Respondents knew how to avoid paying for transmission: by sinking in MISO or overscheduling. Staff Report at 3, 10, 17.

*interest in identifying and capturing such occasional profit opportunities*. Far from it: when they found an OCL Strategy trade that worked well, they took an assembly-line approach, scheduling large-volume trades every hour for long blocks of time, often covering all or most of the on-peak hours. Indeed, the most profitable hour that appears on the exhibit is at HE 6 (*i.e*. from 5 a.m. to 6 a.m.), but the Respondents almost never placed OCL trades for off-peak hours (which also happen to be the hours with the lowest MLSA payments)—in fact, more than 97% of their OCL Strategy trades by volume were done in the HE10-22 time, when load (and therefore MLSA payments) was highest.

The same applies to Respondents' suggestion (Ans. at 49-51) that the screenshots showing Hughes's analysis of SouthImp-Exp on June 17 are materially changed by looking at the "constraints" and "PNL" (Profit & Loss, or P&L) columns that were not included in the excerpts. In neither instance does the information on the screen alter the fact that SouthImp-Exp was a path that yielded no realistic prospect of profits. The added "constraint" information on Exhibit CT-47 cited by Respondents merely shows that Coaltrain's analytical software mistakenly indicated that the path could be affected by constraints, while the P&L information on Exhibit CT-50 simply shows that making trades on the path might have made some money on a tiny fraction of hours when significant positive spreads appeared in the first six months of 2010. The P&L information shown in Respondents' screenshot is plainly erroneous because Hughes entered 32 cents of "charges" but Coaltrain's software reversed the sign and incorrectly treated those as gains. For example, the 50 MWh trades that had a 1 penny spread profit mistakenly showed a $16.50 profit when it should have shown a $15.50 loss (50 MWh * negative 32 cents = negative $16, plus 1 penny spread gain per MWh). This means that while the prospective P&L that Hughes could see was not appealing, the correctly calculated prospective P&L was far worse.

In any event, since Hughes thought the trade involved 32 cents of charges per MWh, 32 cents was the minimum spread necessary to make a net spread gain on the path. But Hughes calculated that the path would have been profitable on its own in only ***15***

*hours out of more than* ***4,000*** *hours* spanning January 1 to June 17, 2010 (or 0.37%).[12] To put that into perspective, the odds of winning at American roulette are 1 in 37 (2.63%, with a 35 to 1 payout).[13] And of course, Respondents were not trying to predict these rare events: they placed SouthImp-Exp trades in huge volumes across the entire peak period (HE10-22), and continued doing so for weeks even though the trades never once realized a positive spread during that time.

### 3. Other Alleged Fact Errors

Respondents raise questions about a few additional details recited in the Staff Report. Even if some of these questions can be resolved in Respondents' favor, none materially changes the overall picture in this case.

Respondents complain (Ans. at 84) that the Staff Report concluded that "the fact that Robert Jones highlighted the most recent days in the 'OCL' column on his computer monitor shows that he was *particularly focused* on those figures," and state that "Staff cites no *facts*" to support this statement. But it speaks for itself that Jones opened an application and then *highlighted* part of it.

Respondents state (Ans. at 85-86; Sheehan *et al.* Answer at 10 (hereinafter "Sheehan Ans.")) that Hughes did not actually create a software tool for automatically submitting OCL trades. They concede that Hughes "created a ticket for a *proposed* enhancement to Coaltrain's application" but argue that it "was *never created*," citing a Spector 360 screenshot from July 22, 2010 for support. Ans. at 85; Hughes Decl. ¶ 7. They then depict a Spector 360 screenshot that, they contend, shows that the OCL auto-submit tool was still unfinished on August 19, 2010. Ans. at 86. This point does not help

[12] The profits would have been smaller than indicated because the software tool treated 32 cents of "charges" as profits rather than as costs. Thus, 50 MWh of trades, each with 32 cent charges, would *pay* $16 in charges. Consequently, the one-cent positive spreads shown for Monday 1/18/10 HE 18 and Thu 2/4/10 HE 10 would have resulted in *losses* of $15.50 for a 50 MWh trade (1 cent spread gain times 50 MWh equals 50 cents, *minus* $16 of charges), instead of *gains* of $16.50 as the application suggests. Even with this significant calculation error, Hughes's analysis showed that the trade would have lost money overall. *See* Hughes Test. Ex. CT-50, Hughes Snapshot 25578 (June 17, 2010, 2:35:25 p.m.).

[13] *See Mathematics of Roulette Betting*, http://probability.infarom.ro/roulette.html.

Respondents: since the IMM repeatedly called Respondents during the 10 days following July 22, asking them to stop making the SouthImp-Exp and NCMPAImp-Exp trades, it is not surprising that they stopped working on the auto-submit tool.

Respondents dispute (Sheehan Ans. at 9) the Staff Report's characterization of the "Loss Finder" application allowing traders to sort for, among other things, MLSA eligibility. But this falls flat because the tool (later renamed as the "Daily Strategy" tool) allowed traders to sort for trades that were eligible for MLSA payments (since it identified whether transactions were imports or exports).[14]

Respondents also state (Sheehan Ans. at 10) that Hughes's reference to "Top 100" results in his programming did not mean he was sorting the results by profitability. Even if that was the case, the fact remains that Hughes was at that time performing database searches to sort and analyze loss credit payments.[15] This type of research and analysis of loss credit payments was consistent with, and done in furtherance of, the OCL Strategy. So notwithstanding Respondents' contention that Hughes "was neither a trader nor an analyst" (Sheehan Ans. at 7), it is evident that what they describe as his "software programming" duties (Sheehan Ans. at 9) put him into the heart of the manipulative trading strategy.

Respondents contend (Sheehan Ans. at 10) that the "net_min" filter that Hughes used in his searches depicted in Hughes Test. Ex. CT-46 sorted by "minimum net value" (i.e. "the poorest performing hour") rather than volatility. But this does not help them. Both SouthImp-Exp and NCMPAImp-Exp turned up using this "poorest performing" filter. *See* Hughes Test. Ex. CT-46. If they were seeking profitable positive spreads, then it does not make sense to sort for the "poorest performing hour" and then select the trades that appear on the resulting list.

Finally, Respondents state (Sheehan Ans. at 10-11) that someone else within the firm's IT department added over-collected loss credits in the trade sheet. But if true, all

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[14] *See, e.g.*, Hughes Test. Ex. CT-124, CT-125).

[15] *See* Hughes Spector 360 Snapshot No. 30029 (June 24, 2010 4:00:30 p.m.); *id.* Snapshot No. 30031 (June 24, 2010 4:01:32 p.m.).

this proves is that someone else added the information to the trade sheet, not that the new information added to trade sheet was unrelated to the OCL Strategy. The identity of the person who added the loss credits to the trade sheet is far less important than the fact that adding the loss credits to the trade was done to make it easier to analyze OCL Strategy trades.

### B. Legal Argument: Respondents' OCL Strategy Manipulated the Market

Next, Respondents contend (Ans. at 16-67) that their OCL Strategy did not constitute market manipulation. They are incorrect. As the Commission recently determined under closely analogous circumstances, market manipulation includes making UTC trades that are "(i) lacking arbitrage or convergence purposes; (ii) placed without regard to market fundamentals of supply and demand; (iii) uneconomic; (iv) placed solely with the intent to garner MLSA payments; (v) without substantive risk; and (vi) deceptive."[16] As the Staff Report shows, those elements is present for the OCL Strategy.

#### 1. Making Uneconomic UTC Trades for the Purpose of Collecting MLSA Payments Constitutes a Manipulative or Deceptive Device or Contrivance

Respondents argue (Ans. at 16-20) that the Staff Report does not describe a violation of law because it does not allege that they "deceived" the market or engaged in wash trading. While it is true that the Staff Report does not allege that Respondents engaged in round-trip trading, they are incorrect in arguing that their conduct was not deceptive. The OCL Strategy was deceptive for the same reasons that the SouthImp-Exp and NCMPAImp-Exp trades at issue in *City Power* were deceptive.[17]

Respondents' own SouthImp-Exp and NCMPAImp-Exp trades were no less deceptive than the same trades made by City Power Marketing, and the Commission's reasoning in that proceeding applies with equal force here. As in *City Power*, the OCL Strategy trades "did not fulfill the purpose of allowing traders to arbitrage the market to

[16] *City Power*, 152 FERC ¶ 61,012 at P 129.

[17] *Id.*, PP 140-141, 160; *see also, id.* PP 115-116.

encourage convergence between the day-ahead and real-time markets."[18] Consequently, the OCL trades "could not and did not provide a benefit to the market."[19] Despite this, the Respondents "placed their trades as market participants would place an arbitrage-based spread trade,"[20] in such a way as "to conceal their nature and purpose and interfere[] with the functioning of the PJM market."[21] Having been deceived in this way, "PJM distributed less in MLSA funds to those market participants who were engaged in behavior supportive of and beneficial to the PJM market and instead provided those MLSA funds to Respondents."[22] And even those OCL Strategy trades that realized a tiny spread gain were deceptive and fraudulent; this includes NCMPAImp-Exp as well as the minority of other 38 OCL paths that showed small positive spreads. As the Commission held with regard to City Power's NCMPAImp-Exp trades, "the Respondents defrauded PJM into allocating MLSA payments to Respondents by engaging in high volumes of NCMPAIMP-NCMPAEXP trades solely to collect MLSA payments, despite a small price spread between the points."[23] In short, the parallels between what City Power did and what Respondents did are plain to see, and Respondents' conduct was deceptive for the same reasons.

### 2. <u>The Staff Report Does Not Promulgate a Novel Definition of Manipulation</u>

Respondents also contend (Ans. at 20-24) that the definition of manipulation used in the Staff Report is novel. They are wrong.

First, Respondents assert (Ans. at 21- 23) that "low" risk trading is not manipulative, that the definition of "low" risk is too vague, and that they did not have fair notice that "low" risk trading was unlawful. These arguments misconstrue the allegations

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[18] *Id.* P 141.

[19] *Id.* P 160.

[20] *Id.* P 141.

[21] *Id.* P 160.

[22] *Id.* P 160.

[23] *Id.* P 160.

in the Staff Report, and are wrong on the law. The Staff Report did not define "low risk" as *per se* manipulative. Rather, the issue is *whether the trades were made to profit from price spreads*, which is the purpose of UTCs. The Commission has repeatedly and consistently analyzed potentially manipulative conduct in this way. For instance, in *Barclays*, the Commission described manipulation as including trading "in a manner that was inconsistent with fundamental supply and demand concerns."[24] In *City Power*, the Commission found that trades on Coaltrain's two most profitable OCL paths (SouthImp-Exp and NCMPAImp-Exp) were manipulative because they were placed "without regard to market fundamentals and with the intent to benefit not from the spread on UTC trades but solely from the MLSA payments."[25] That was how the Staff Report also repeatedly described and defined manipulative conduct: trading "inconsistent with the fundamentals of supply and demand."[26]

Thus, this case is *not* about the precise quantum of risk necessary for a trade to be non-manipulative. Indeed, "risk" is not the issue here; the issue is whether the trades—regardless of their level of risk—were made in accordance with market fundamentals. As addressed at length in the Staff Report, the answer is no—not because they were low risk, but because the evidence overwhelmingly shows that they were uneconomic trades aimed not at arbitrage but at MLSA payments.[27]

Next, Respondents argue (Ans. at 23-24) that they did not trade for the "purpose" of collecting MLSA payments, and that "even assuming that a party had executed a trade solely to collect MLSA, due process prohibits the Commission from sanctioning that

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[24] *Barclays Bank PLC, et al.*, 144 FERC ¶ 61,041 at P 32 (2013).

[25] *City Power*, 152 FERC ¶ 61,012 at P 61.

[26] Staff Report at 70, 74, 78, 83.

[27] Respondents also contend (Ans. at 22) that the case against Coaltrain is unlike the facts presented in *Chen* and *City Power* because "Coaltrain never engaged in 'wash trades' or 'round-trip' transactions." That is a red herring. The Commission found in *City Power* that directional trades such as SouthImp-Exp and NCMPAImp-Exp were manipulative when done to collect MLSA payments—and did not find those trades unlawful simply because City Power separately executed round-trip trades.

trade as market manipulation because the Commission provided no prior notice that such trades were unlawful." But this reflects a fundamental misunderstanding of the facts and law. As to the first point, the evidence recited at length in the Staff Report is clear and unmistakable: the OCL Strategy was conceived and executed as a way to profit from MLSA payments. For instance, the pattern of trading was inconsistent with an attempt to profit from price spreads absent MLSA; the trades were actually almost certainly losers; and even their own description of the "OCL Strategy" shows what Respondents were trying to achieve, as opposed to their lawful "Spread Strategy" based on market fundamentals.

As the Commission has explained, UTC trades are designed to enable traders to try to profit from successful arbitrage of Day-Ahead and Real-Time spreads; profiting from MLSA on trades that are uneconomic as spread trades has nothing to do with that purpose. Nor does anything in the *Black Oak* proceeding help Respondents: the Commission did not approve placing uneconomic UTC trades solely for the purpose of collecting MLSA.[28] Moreover, the Commission itself has already determined "that the MLSA payments were not, and should not be considered, part of the underlying UTC trade" and that "[s]peculative UTC trades placed to arbitrage price spreads will have as their sole or primary price signal the price risk of the underlying UTC spread and will be placed with the purpose of profiting based on the direction of the spread."[29]

Furthermore, it is wrong to suggest that the Commission's anti-manipulation authority is limited to violations of tariffs or conduct that has already been specifically defined, or that the Respondents did not have fair notice. *See* Ans. at 21-23, Peter Jones, *et al.* Answer at 16-17 (Jones Ans.). The Anti-Manipulation Rule does not require tariff violations, and the Commission has found that conduct that is consistent with the literal terms of the tariff nevertheless may violate the rule.[30] Meanwhile, FPA section 222[31]

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[28] *City Power*, 152 FERC ¶ 61,012 at P 168.

[29] *Id.* PP 102-103; *see also, Chen*, 151 FERC ¶ 61,179 at PP 78, 80.

[30] *See, e.g., In re Make-Whole Payments and Related Bidding Strategies*, 144 FERC ¶ 61,068 (2013).

requires the Commission to adopt regulations that protect electric ratepayers, and the Anti-Manipulation Rule encompasses the full range of fraudulent conduct that can occur.[32] Fair notice requires the Commission to adopt language that a "reasonably prudent person, familiar with the conditions that the regulations are meant to address and the objectives the regulations are meant to achieve, [has] fair warning of what the regulations require."[33] As discussed in the *City Power* order, "Commission precedent invalidates any claim of ambiguity concerning the scope of our Anti-Manipulation Rule."[34] As the Commission has made clear for years, "fraud is a question of fact that must be determined based on the particular circumstances of each case"[35] and is defined in the Commission's jurisdictional markets as "impairing, obstructing or defeating a well-functioning market"[36] Here, the Respondents were on notice that MLSA payments were not part of the underlying UTC trade, and that making UTC trades for purposes contrary to the fundamentals of supply and demand was unlawful. The fact that the Respondents concealed their plans and made misleading statements about their intent to do the OCL trades in a June 2010 filing in the *Black Oak* proceeding refutes any notion that they were unaware that the OCL Strategy was outside the bounds of legitimate trading.[37]

### 3. <u>The OCL Strategy Involved Uneconomic UTC Trades To Collect MLSA</u>

Respondents also argue (Ans. at 24-52) that the OCL Strategy trades were not manipulative. In particular, they contend that the trades were "not risk-free" (Ans. at 24-

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[31] 16 U.S.C. 824v (2012).

[32] *City Power*, 152 FERC ¶ 61,012 at P 164; *Chen*, 151 FERC ¶ 61,179 at P 116 n.283.

[33] *City Power*, 152 FERC ¶ 61,012 at P 165 (quoting *Freeman United Coal Mining Co. v. Fed. Mine Safety & Health Review Comm'n*, 108 F.3d 358, 362 (D.C. Cir. 1997)).

[34] *City Power*, 152 FERC ¶ 61,012 at P 166.

[35] Staff Report at 74 (citing Order No. 670, FERC Stats. & Regs. ¶ 31,202 at P 49; *City Power*, 152 FERC ¶ 61,012 at P 58 (citing Order No. 670, FERC Stats. & Regs. ¶ 31,202 at P 49); *Chen*, 151 FERC ¶ 61,179 at P 49 (same)).

[36] *Prohibition of Energy Market Manipulation*, Order No. 670, FERC Stats. & Regs. ¶ 31,202, at P 50 (2006).

[37] *See* Staff Report at 91-92 (discussing misleading statements in June 2010 filing).

33), were not made for the "purpose" of collecting MLSA (Ans. at 33-37), and were driven by market fundamentals instead of MLSA credits (Ans. at 37-52). In making these arguments, they rely extensively on a paper prepared by their consultant (Lesser) and attached to the Answer. But these claims are contradicted by the evidence, which overwhelmingly points to the conclusion that the trades made pursuant to the aptly-named OCL Strategy were manipulative.

**a. <u>The OCL Strategy Trades Were Uneconomic</u>**

Respondents contend (Ans. at 24-33) that their OCL Strategy trades were not "risk-free" because (1) the price spreads were volatile (Ans. at 27-30); (2) the MLSA amounts were volatile (Ans. at 30-31); (3) the trades had transaction risk (Ans. at 31-32); and (4) they executed other trades to "hedge" their OCL Strategy trades (Ans. at 32-33). None of these propositions contradict the Staff Report's finding that the OCL Strategy trades were manipulative.

As an initial matter, Respondents' contention that manipulation requires proof that their trades were "risk-free" is a strawman. As discussed above, risk is not the issue here, nor is there any specific quantum of risk that makes a trade non-manipulative. Instead, the proper question is whether the trades were done based on the fundamentals of supply and demand, and not for some ulterior motive—in this case, diversion of MLSA from market participants placing bona fide transactions.

As the trade data shows, the OCL Strategy trades, unlike Respondents' Spread Strategy trades, had little upside or downside on the merits, and Respondents knew it. The reason they chose paths with minimal volatility for the OCL Strategy is simple: if the point is to capture MLSA payments, the way to make a profit is to do a lot of volume and collect more dollars in MLSA payments than are lost on charges and price spreads. Since the per-MWh difference between on-peak MLSA payments during the summer of 2010 (*i.e.* at the times when they scheduled their OCL Strategy trades) and UTC charges (including transmission reservation charges) was typically about a dollar (during peak hours, when Respondents did nearly all of their OCL trades), there is little room for downward volatility. And since Respondents scheduled enormous volumes on their OCL

trades, an adverse price spread would have been disastrous—even a small downward swing in average hourly spreads could have resulted in enormous losses in a single day because of the huge trading volumes involved. Thus it is not surprising that one consequence of their manipulative scheme was that they found it necessary to *look for and make uneconomic* trades—that is, UTC trades whose anticipated spreads were reliably zero or near-zero *(i.e*. below even unavoidable charges). They were not trying to profit from spreads but, just the opposite, they were trying to neutralize or minimize spreads to avoid volatility and achieve profitability through the MLSA payments.

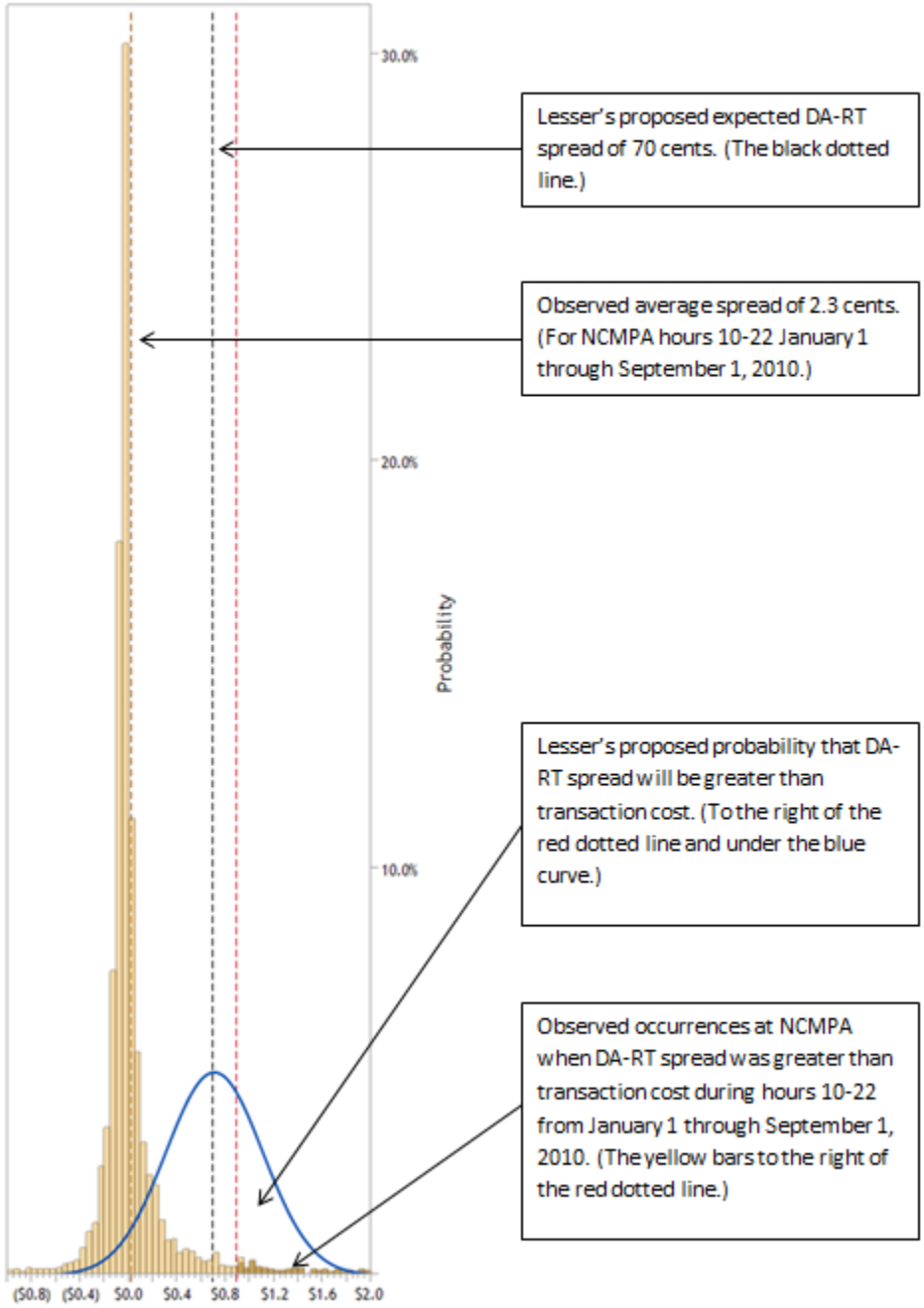
Contrary to what Respondents suggest (Ans. at 26), they did *not* make profits "on 13 of the 40 paths (33%) before accounting for MLSA." Rather, they realized positive gains *before unavoidable charges* (*i.e*. not including transmission reservation charges) on 13 of the 40 paths but, in large part because they voluntarily increased their transaction costs by paying for transmission when they knew it was not necessary to do so, they made a pre-MLSA profit (*i.e*. spreads less charges) on only two of the paths for a total sum of $3,088. *See* Staff Report at 34. Similarly, the fact that they realized positive spreads amounting to slightly more than $124,000 on the NCMPAImp-Exp trades is dwarfed by the more than $893,000 in transaction costs they paid to make the trades, largely due to their voluntary decision to pay for transmission. Thus they lost more than $769,000 on their NCMPAImp-Exp trades absent MLSA. In total, as the Staff Report indicates (at 34), Respondents lost more than $96,000 on the OCL trades (including NCMPAImp-Exp) on price spreads alone, and that sum increased to more than $3.9 million after transaction costs.

Next, Respondents and their consultant contend that the price spreads associated with Coaltrain's UTC trades were quite volatile. Ans. at 27-30. This argument is inconsistent with their contention that their trades were also "low risk" (*e.g.* Ans. at 3, 14, 37). In addition, Respondents provide a misleading analysis in an attempt to "prove" that the OCL Strategy trades were highly volatile. They argue that volatility is the accurate measure when analyzing price spreads. However, the evidence does not show that Respondents chose the OCL paths because of their volatility. Instead, the evidence

overwhelmingly indicates that Coaltrain transacted at the OCL locations because the expected spread was zero or close to zero. Moreover, as shown below, Respondents' focus on one measure of volatility ignores the fact that, for these trades, only a minuscule fraction of hours experienced significant price spikes.

Lesser's analysis of the distribution of price differences is also misleading. At Figure 5 (Lesser at P 99), Lesser contends that Coaltrain's trades were not illegitimate because of volatility. Figure 5 uses a bell curve to illustrate his point about price differences. The problem is that the bell curve shown on Figure 5 does not even remotely approximate the actual distribution of the spreads associated with the OCL trades. Furthermore, Lesser uses a theoretical DA-RT spread of 70 cents as the most common price. But this is also detached from the actual trade data at issue here. To take an example, 2.3 cents was the mean price-spread of NCMPAImp-Exp from January 1 to September 1, 2010 for HE 10-22 (the hours when Coaltrain primarily made its NCMPAImp-Exp trades). The following graph compares Lesser's theoretical model to the actual distribution of price spread of NCMPAImp-Exp between January 1, 2010 and

September 1, 2010, HE 10-22:[38]




As this graph shows, Lesser's theory wildly deviates from what actually happened. The distribution of price-spreads at NCMPAImp-Exp shows that it did not promise realistic profits, particularly with a large-volume assembly-line approach to trading (which is what

[38] PJM Dataminer; *see also*, Staff Report at 79 n.324.

Coaltrain actually did)—and it was even less realistic to make a profit after paying for transmission. Data such as these further demonstrates that it was MLSA, not positive price spreads, that drove the OCL Strategy. Whatever the merits of Lesser's model in a cloister, his theory has no basis in fact.

### i. The OCL Trades Were Not Made To Profit From Price Spreads

**SouthImp-Exp.** Respondents first argue that SouthImp-Exp experienced significant volatility. Ans. at 27-28; Lesser at PP 176-199. This is not correct. As an initial matter, Lesser's analysis is replete with material errors of fact, despite the fact that this was his *second* report in this proceeding. To state an obvious example, he claims (Lesser at P 189, Table 4) that the "maximum price spread" between January 1, 2010-September 1, 2010 at SouthImp-Exp was $37.20, and the "minimum price spread" was a *loss* of $32.16, as follows:

**Table 4: SouthImp-SouthExp DA-RT Price Spreads, January 1, 2010 – September 1, 2010**

| Item | Amount |
|---|---|
| Maximum Price Spread | $37.20/MWh |
| Minimum Price Spread | ($32.16)/MWh |
| Percentage of Hours with Non-Zero DA-RT Spread | 68% |
| Average Price Difference | ($0.32)/MWh |
| Std. Deviation (volatility) | $1.46/MWh |
| Coefficient of variation | 461% |
| Percent Hours when MLSA Credit < 89-cent/MWh Transaction Cost (6/1/2010 – 9/1/2010) | 44% |

Source: PJM Dataminer; PJM Loss Simulator.xls

But this table is replete with errors. **First**, Lesser makes an elementary but critical mathematical error: he has his signs *reversed*. In fact, the *maximum* price spread was $32.16, and the *minimum* spread was -$37.20.[39] That is so because the trade can only be

[39] Profits for SouthImp-Exp are represented by the RT spread minus the DA spread, and the RT spread is generated by subtracting the source (SouthImp) from the sink (SouthExp). Lesser himself accurately represents the basic algorithm (at P 75) as "$[RT_B\text{-}RT_A] – [DA_B – DA_A]$ where

done FROM SouthImp TO SouthExp, which means that the trade makes money only when Real-Time SouthExp is *larger* than Real-Time SouthImp (put differently, one *buys* Real-Time SouthImp and *sells* Real-Time SouthExp). The Respondents parrot Lesser's mistake in their brief. Ans. at 28. **Second**, the average price spread during that period was -$0.22, *not* -$0.32 as Lesser represents.[40] **Third**, the actual standard deviation between January 1, 2010 and September 1, 2010 was $1.16, *not* $1.46 as he reports. **Fourth**, the percentage of hours with nonzero spreads between January 1, 2010 and September 1, 2010 was 43%, *not* 68% as he represents.[41]

Even the "correct" data included in this table are misleading. For instance, Lesser claims that the percentage of hours when MLSA credit was less than 89 cents per MWh was 44% for the period June 1 through September 1, 2010. This figure is an average of all 24 hours during the day during that period. But since load is lower at night than during the day, the MLSA figure was correspondingly lower in those hours. Not coincidentally, *Coaltrain did not make its OCL Strategy trades during all hours*; about 97% of its OCL Strategy trades by volume were between HE 10 and HE 22, when load (and MLSA) was highest. And what was the percentage of hours HE 10-22 when MLSA payments were less than 89 cents per MWh? *Just 8.4 percent*, five times less than what Lesser represents.[42] Furthermore, Lesser provides his calculation of the "Coefficient of Variation" (CV) to illustrate the volatility of the price spread to validate Coaltrain's expectation of profitability at SouthImp-Exp. However, when calculating the CV, if the

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"A" is the Source and "B" is the Sink. Thus, because SouthImp-Exp *always* settled at perfectly zero in the DA market, that means that profits are determined solely by subtracting RT SouthImp from RT SouthExp. Thus, when RT SouthImp is $25.49 and RT SouthExp is $57.65 (as it was on April 2, 1010, HE 8), the trade *profited* by $32.16, but Lesser mistakenly represents that the trade lost money. *See also* Coaltrain Resp. to Third Data Request, Spread Sheet Responses (W3122560), Tab Question 17-1 (HRLY) (May 25, 2012) (showing the correct price spreads with the correct price signals); Coaltrain Resp. to Second Data Request, Question 3 Comments, Document 4 (Dec. 9, 2010); Bates No. COALTRAIN000034 (same).

[40] For the period January 1 through June 17, 2010, the average price spread was -$0.32, but extending that period to September 1, as Lesser's table suggests, reduces the spread to -$0.22.

[41] Source: PJM Dataminer.

[42] *See* 04.5-DR4-Simulated Loss Credit Rate by type Aug2008-Sept16-2010.xls

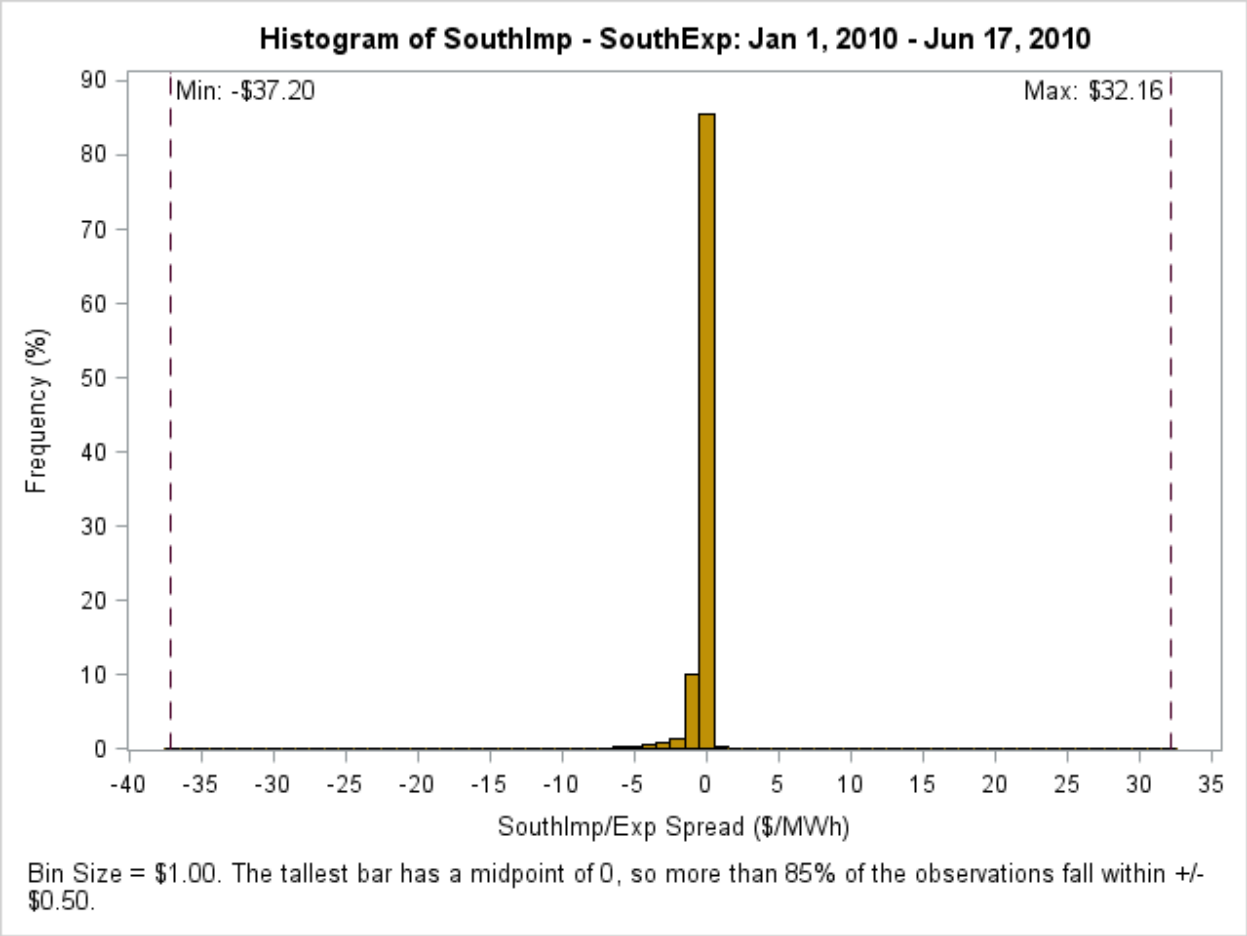
mean of one of the variables (in this case, the price spread) is zero or close to zero (as is the case with SouthImp-Exp), the CV will likely be very large and meaningless.[43] Therefore, Lesser's CV is not a reliable metric from which to draw conclusions. Additionally, there is no contemporaneous evidence to indicate that Coaltrain was relying on this statistic when making trading decisions.

Setting aside Lesser's mistakes,[44] his discussion of volatility on SouthImp-Exp is misleading. The following chart depicts the price differences at SouthImp-Exp that

[43] As one scholar explains, "Variates with a mean less than unity [*i.e.* below one] will also provide spurious results and the coefficient of variation will be very large and often meaningless." Charles E. Brown, *In Applied Multivariate Statistics in Geohydrology and Related Sciences*, 155-157 (Springer Berlin Heidelberg GmbH & Co., eds. 1998) (chapter titled *Coefficient of Variation*). *See also*, Institute for Digital Research and Education, UCLA, *FAQ: What is the coefficient of variation?* http://www.ats.ucla.edu/stat/mult_pkg/faq/general/coefficient_of_variation.htm ("There are some requirements that must be met in order for the CV to be interpreted in the ways we have described. The most obvious problem arises when the mean of a variable is zero. In this case, the CV cannot be calculated. Even if the mean of a variable is not zero, but the variable contains both positive and negative values and the mean is close to zero, then the CV can be misleading. The CV of a variable or the CV of a prediction model for a variable can be considered as a reasonable measure if the variable contains only positive values. This is a definite disadvantage of CVs.").

[44] Lesser also claims (though he does not purport to have first-hand knowledge) that "Coaltrain did not learn that SouthIMP and SouthEXP nodes were equivalent until it participated in a phone call" with the IMM. Lesser at PP 198-199.

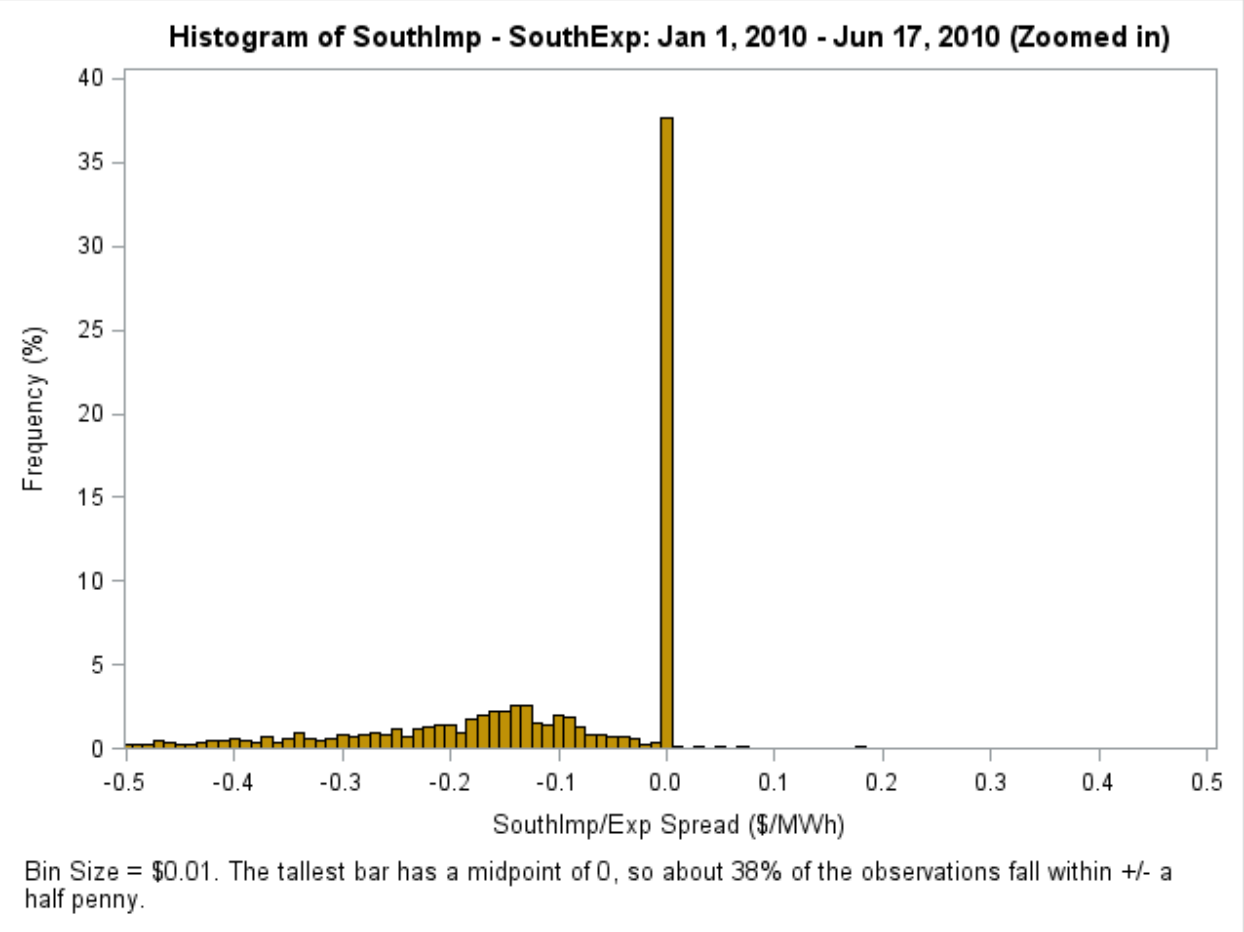
Hughes would have seen when he did his first analysis of the path:[45]




This chart shows the frequency and distribution of price spreads on SouthImp-Exp from January 1 through June 17, 2010. (The x-axis represents the price spread with the bars in $1.00 increments, and the y-axis depicts the frequency.) As this chart demonstrates, and contrary to Lesser's analysis, there was remarkably *little* volatility on SouthImp-Exp. Much of the time (38% during the period 1/1/10 through 6/17/10), the path settled exactly at *zero*, and out of the 4,031 hours during that period, the path had a *positive* settlement—even just a penny—in only 49 hours, and lost a dollar or more in 269 hours. By contrast, in 3,417 hours (85% of the time) the trade settled between zero and *negative* fifty cents,

[45] PJM Dataminer. *See also*, Bates No. COALTRAIN011535.

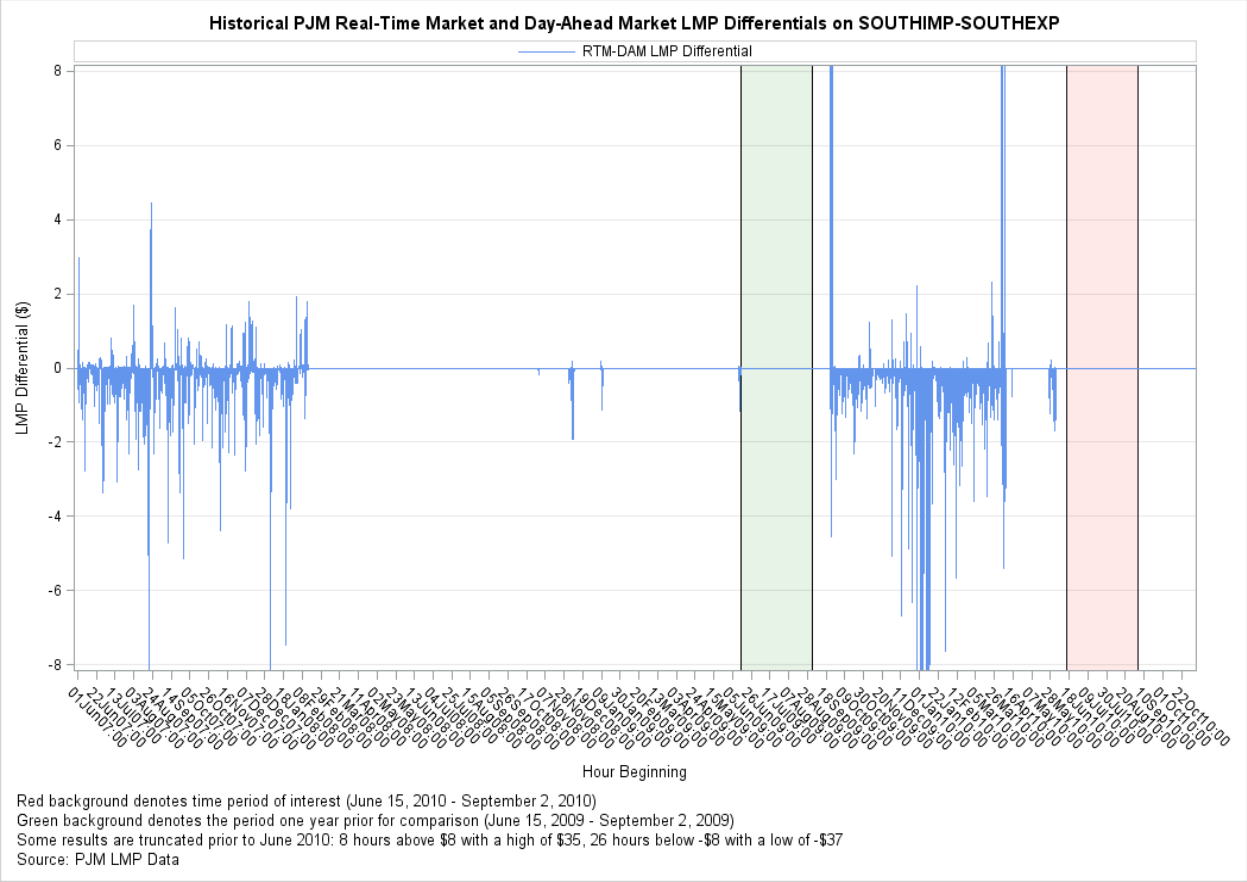
as the following chart shows:[46]




This chart is simply a magnification of the previous histogram to make the rare price spreads more visible by showing only the times when the spread was between negative fifty cents and positive fifty cents (the bars in this case are in $0.01 increments). What this illustrates is that Hughes and others would have seen that on the occasions when a price spread did appear on SouthImp-Exp during that period, it was almost always negative. Therefore, a trader unaware that SouthImp-Exp were tied together would have seen that the trade usually lost money when it didn't settle at zero, and that the price spreads (when they occurred at all) were exceptionally narrow. Traders who were actually trying to profit from price spreads (as opposed to targeting MLSA payments) would not continue to trade on this path after losing money on it, day after day.

[46] PJM Dataminer.

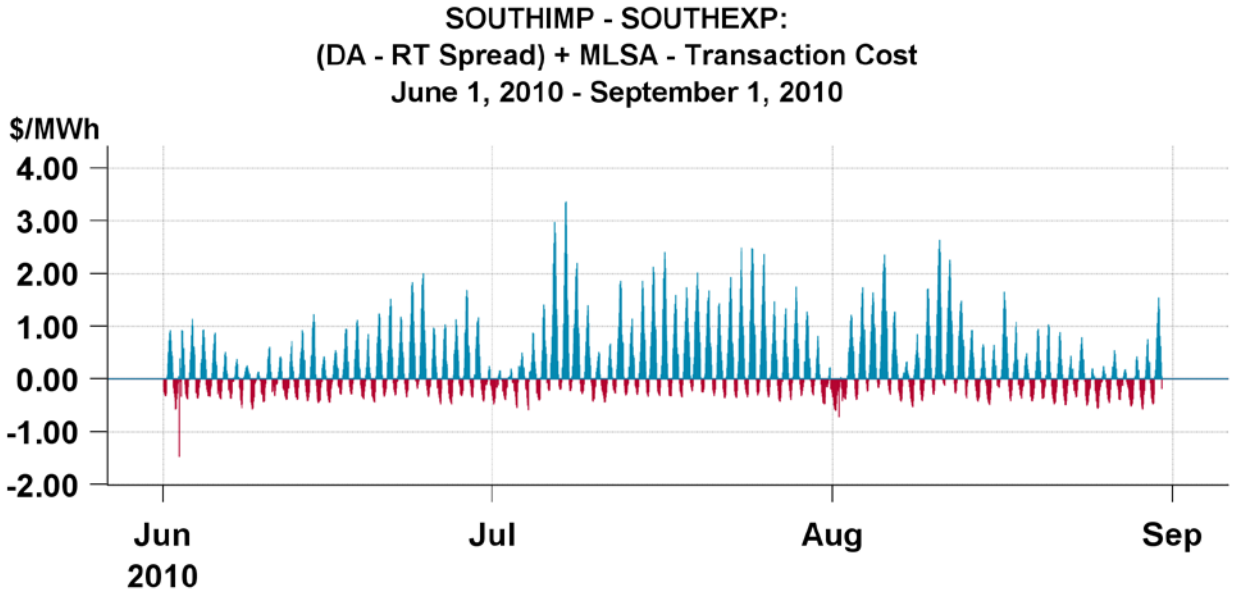
This unappealing path did not improve with age. Between July 1, 2007 and August 19, 2010, SouthImp-Exp settled at non-zero less than 38% of the time, and the same lack of volatility seen in 2010 appears in the longer history as well, as a chart included in the Staff Report demonstrated:[47]




Moreover, Figure 15 of Lesser's report, which purports to show the net hourly profitability of SouthImp-Exp between June 1 and September 1, including MLSA payments, is also misleading. Lesser's inclusion of off-peak hours makes the net profitability (including MLSA) look somewhat variable (this is a replication of what

[47] *See also*, Staff Report at 79 ("The chart shows that on the occasions when SouthImp-Exp experienced price divergence, the vast majority of the time it was negative—and, since SouthImp-Exp can be traded only in one direction (from SouthImp to SouthExp), that means that the trade would lose money.").

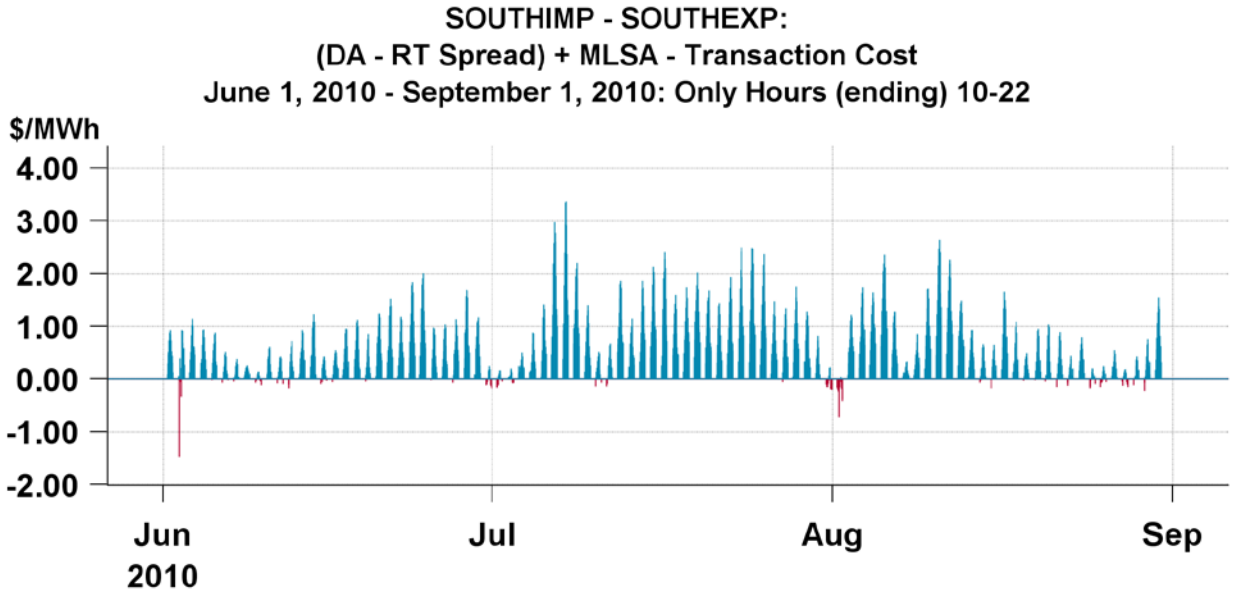
Lesser did in his Figure 15): [48]




But nearly all (98.5%) of Coaltrain's SouthImp-Exp trades by volume were done during HE 10-22. Applying Lesser's formula just to those hours shows that SouthImp-Exp trades (which always had zero spreads during the summer) almost always had MLSA payments greater than transaction costs during the HE10-22 hours when Coaltrain

[48] Lesser at 67.

actually placed its trades:[49]




That is, Coaltrain knew that SouthImp-Exp was reliably profitable *because of MLSA* during the best peak hours, and therefore traded during those hours and not during low-MLSA night and early morning hours.

In short, SouthImp-Exp was not "volatile" in any meaningful way. To any rational trader seeking to profit by arbitraging price spreads, SouthImp-Exp was not a rational trade. It settled at or near zero most of the time (and 100% of the time during the period when Coaltrain placed trades on that path), it lost money most of the time when spreads did appear, and the handful of significant positive spreads that appeared were too small and too rare to cover the losses that would inevitably arise from frequent trading. Theoretically, a bold trader unaware that the nodes were supposed to be tied together might try to guess the exceptionally rare hours when a SouthImp-Exp trade would be profitable on the merits, but that is not what Coaltrain did. Its strategy was different, and simple: place huge-volume trades during peak hours when MLSA would be predictably high, even though the trade was virtually certain to generate zero or near-zero spreads.

[49] PJM Dataminer; 04.5-DR4-Simulated Loss Credit Rate by type Aug2008-Sept16-2010.xls.

Respondents also state (Sheehan Ans. at 12-13) that Sheehan's IM response to learning about SouthImp-Exp was "da da perfectly 0 [zero]" was a simple statement of surprise, and that he did not propose trading SouthImp-Exp or NCMPAImp-Exp, nor was he verifying that there was no price spread on SouthImp-Exp. However, the statement "da da perfectly 0 [zero]" itself shows that he immediately realized that there was no spread in the Day-Ahead market for SouthImp-Exp, and it strains credulity to suggest that it is a coincidence that Sheehan's partner Peter Jones scheduled Coaltrain's first-ever SouthImp-Exp trades the very next morning.[50]

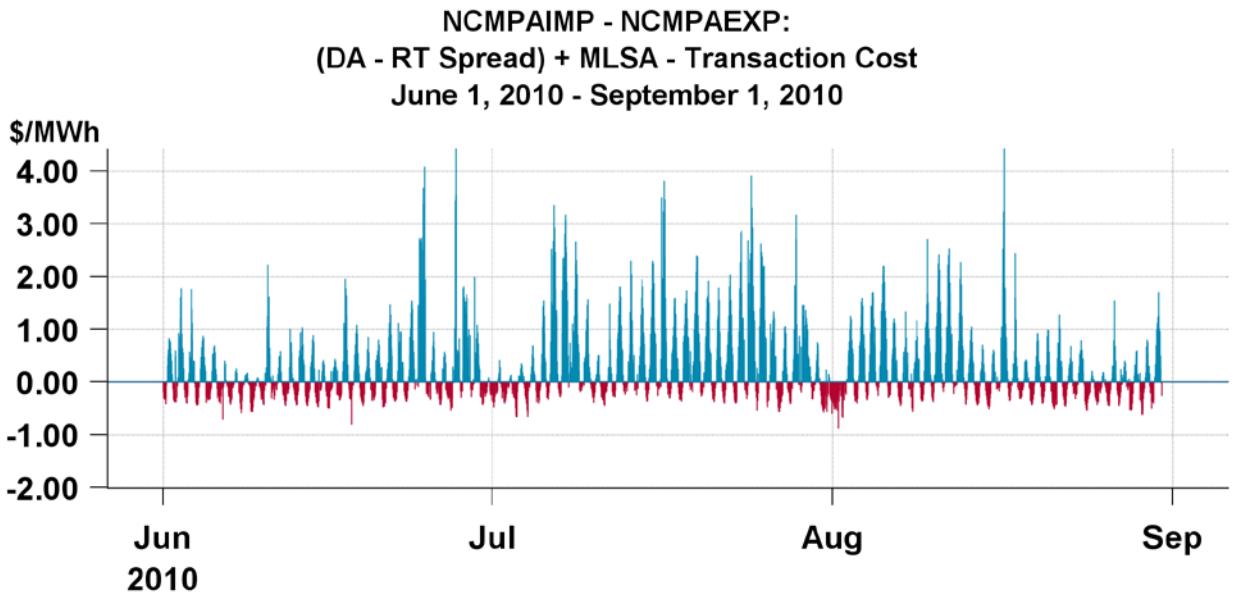
**NCMPAImp-Exp.** Lesser and the Respondents also claim that the NCMPAImp-Exp spread was highly volatile. Once again they point to the minimum and maximum values and the standard deviation. Ans. at 28-29, Lesser at PP 200-203. But once again, noting the maximum variance is misleading because (as shown above) the spreads on NCMPAImp-Exp did not have a normal (*i.e*. bell curve) distribution. Far from it: of the 5,855 hours between January 1 and September 1, 2010, 4,944 of those hours (84%) had price spreads between positive 20 cents and negative 20 cents, while 3,895 of the hours (more than 66%) had price spreads between positive ten cents and negative ten cents.[51] In only 548 hours (9%) did the positive price spread on NCMPAImp-Exp exceed 20 cents during that time, and only 145 of those hours (2.48%) had a positive price spread exceeding 89 cents. That means that a trader rationally looking at this trade would see that it offered the prospect of profits (before transmission charges) less than 9% of the time, and the profits would exceed all charges (including transmission reservation) less than 2.5% of the time. Such a path would make no sense for massive trades placed indiscriminately across many hours during the peak time of day. As the NCMPAImp-Exp histogram on page 24 shows, because gaining 20 cents on the spread is not enough to pay for even the unavoidable charges of entering into UTC trades at that time, this graph shows that NCMPAImp-Exp was not a rational opportunity for traders seeking to profit

[50] Bates No. COALTRAIN011540 (first SouthImp-Exp trades scheduled by Peter Jones on June 18, for execution on June 19).

[51] Source: PJM Dataminer.

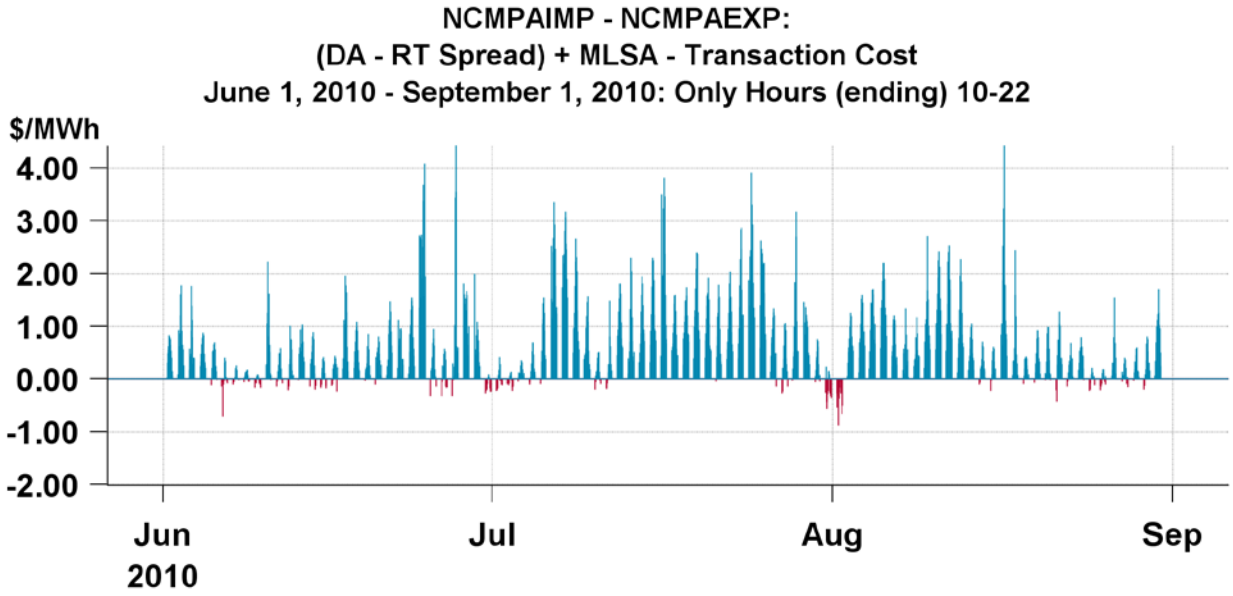
from price spreads because 90% or more of the hours would have lost money (absent MLSA). Again, as with SouthImp-Exp, a different hypothetical trader might try to isolate specific hours in which the path might be profitable on the merits, but that is not what Coaltrain did: once it started trading NCMPAImp-Exp, it often traded 5,000 to 10,000 or more MWh per hour for twelve or more hours a day, far longer than its legitimate arbitrage trades under the Spread Strategy. The path predictably showed minimal average spreads (about 11 cents/MWh), which happened to be positive during this period, but not nearly enough to pay for the basic charges of doing UTC trades (much less the transmission Coaltrain voluntarily purchased). The only reasonable inference from this pattern of trading is that Coaltrain was seeking to profit from something other than the price spreads. That purpose is expressed in the name Coaltrain chose for the strategy: "OCL" (*i.e.*, MLSA).

Lesser (at Figure 17) provides a chart of net profitability on NCMPAImp-Exp in the summer of 2010, including MLSA payments. His chart appears to show that NCMPAImp-Exp was volatile and risky (what follows is Enforcement's replication):




But, like his SouthImp-Exp chart, this one is misleading because it includes *all* hours. Limiting the data to include only the hours when Respondents almost always (95% of the time by volume) traded NCMPAImp-Exp (HE 10-22), shows that the path was profitable

with MLSA during the peak hours:[52]




Notice that the losses (in red) largely disappear. This chart thus reveals that Lesser ignored that Respondents made their MLSA-collecting trades during the hours when MLSA payments were highest.

**38 Other OCL Paths.** Respondents also argue (Ans. at 29-30, Lesser at PP 204-230) that the 38 other OCL paths experienced significant price volatility. Respondents also emphasize that they traded on some of these paths before MLSA became available, and that they traded on some after MLSA was taken away. Ans. at 30, Lesser at PP 216, 225-226. But these arguments are not persuasive. As with SouthImp-Exp and NCMPAImp-Exp, trading on a particular path is not, *per se*, either lawful or unlawful. For instance, the Commission noted that City Power Marketing placed a series of NCMPAImp-Exp trades between February and April 2010—before the respondents there had discovered their own version of the "OCL Strategy"—but did not find that those particular trades (placed with free transmission) were manipulative or treat them as

[52] PJM Dataminer; 04.5-DR4-Simulated Loss Credit Rate by type Aug2008-Sept16-2010.xls.

exculpatory of the manipulative NCMPAImp-Exp trades (with voluntarily paid transmission) that City Power placed in July 2010.[53]

The pertinent question is whether Respondents made the trades in question not to capture price differences but rather to lay a volumetric claim on MLSA payments. The evidence proving that their SouthImp-Exp and NCMPAImp-Exp trades were manipulative includes the fact that those paths made no sense to trade in the manner that Coaltrain actually traded them (*i.e*. large-volume trades made for many hours of nearly every day); that Coaltrain labeled the trades with the "OCL Strategy" moniker; and that Coaltrain voluntarily paid for transmission. The record likewise proves that Respondents devised and executed OCL Strategy trades on 38 other paths that summer as part of the manipulative scheme. First, Respondents themselves identified the trades as "OCL Strategy" trades—not as "Spread" trades (which were intended to profit from arbitrage). That alone is a powerful indication of their intent in making those trades, despite Lesser's contrary view.[54] Second, Coaltrain voluntarily increased its transaction costs for these OCL trades by paying for transmission when they knew it was not necessary to do so—in contrast to what Coaltrain did before the OCL Strategy was executed, or after.

In response, Lesser argues that because Respondents had made trades on six of the 38 paths before June 15, 2010, that means that later trading on those paths cannot be

[53] *City Power*, 152 FERC ¶ 61,012 at PP 156-157 (noting that City Power used free transmission for those trades).

[54] Lesser at P 224 (saying that it is "absurd" to infer manipulative intent from Respondents' own labels). It is not clear what expertise Lesser claims to have in such matters.

manipulative. He provides the following table to support his proposition:[55]

**Table 7: Paths Along Which Coaltrain and Its Predecessor Scheduled UTCs Prior to MLSA Eligibility**

| No. | Path (Source – Sink) | Dates Traded |
|---|---|---|
| 1 | OVEC – BECKJORD6 | 11/20/2008 |
| 2 | BEAV DUQ UNIT1 – MICHFE | 3/26/2008-6/14/2010 |
| 3 | AK STEEL – SOUTHWEST | 12/27/2008 – 9/2/2009 |
| 4 | OVEC – MIAMI FORT 7 | 4/22/2009 |
| 5 | CPLEIMP – DUKEXP | 6/12/2010 – 6/14/2010 |
| 6 | ROCKPORT – SOUTHWEST | 3/24/2009 – 4/11/2010 |

Source: Coaltrain Response to OE-CT-2-1.

But this evidence does not exonerate Respondents. As an initial matter, the Staff Report does not state that making trades on any of the OCL paths was a *per se* manipulative act. (This is similar to how the Commission did not find that the NCMPAImp-Exp trades that City Power made in the spring of 2010 had been manipulative.)[56] What matters instead is whether the evidence (including the trading behavior) shows that the trades were made for legitimate or manipulative purposes. In the case of the trades Respondents made on the OCL paths before June 15, the evidence shows that the early trades were done for legitimate purposes, and that the trades during the summer of 2010 were done to manipulate the market by targeting MLSA instead of price spreads. In fact, the Commission found that the difference between the way that City Power traded NCMPAImp-Exp in the spring from the way it traded the same path in the summer provided further proof that the summer trades were manipulative. That is also the case here.

As an initial matter, Lesser missed one MLSA-eligible OCL path that Coaltrain had traded before June 15: OVEC-Tanners Creek 3. Enforcement includes the trades on this extra path in the analysis below.

[55] The significance of "June 15" is this is the day when Coaltrain's records indicate that it began self-consciously making OCL trades.

[56] *City Power*, 152 FERC ¶ 61,012 at P 156.

There are important differences between the way in which Coaltrain traded on those paths before June 15, and the way it traded those paths during the OCL Strategy period. Put simply, the pre-June 15 trades (done to profit from price spreads) featured much smaller volumes, greater price sensitivity to DA-RT losses, far less concentration in the hours when MLSA payments were highest, and less willingness to pay to reserve transmission:[57]

**OCL Paths Traded Before June 15, 2010**

| | Trades before June 15, 2010 | | | | OCL Trades | | |
|---|---|---|---|---|---|---|---|
| Path (Source - Sink) | % Prior to Oct 2009 | MWh per Trade | % Bid in HE 10-22 | % Paid Trans-mission | MWh per Trade | % Bid in HE 10-22 | % Paid Trans-mission |
| OVEC - BECKJORD 6 | 100% | 50 | 0% | 100% | 256 | 95% | 100% |
| OVEC - MIAMI FORT 7 | 100% | 25 | 92% | 100% | 259 | 97% | 100% |
| OVEC - TANNERS CRK 3 | 100% | 50 | 0% | 100% | 254 | 92% | 100% |
| AK STEEL - SOUTHWEST | 100% | 41 | 78% | 0% | 221 | 98% | 100% |
| BEAV DUQ UNIT1 - MICHFE | 94% | 83 | 47% | 2% | 200 | 100% | 100% |
| ROCKPORT - SOUTHWEST | 76% | 71 | 50% | 2% | 173 | 69% | 30% |
| CPLEIMP - DUKEXP | 0% | 111 | 54% | 100% | 105 | 78% | 100% |

What this shows for each path is that the pre-June 15 trades were legitimate (and by definition the trades made before October 2009—*i.e.* before MLSA was made available to UTC trades—were not made to collect MLSA), while the OCL Period trades were manipulative, as follows:

- **One-Day Trades:** Three of the paths (OVEC-BeckJord6, OVEC-Miami Fort 7, and OVEC-Tanners Creek 3) each were traded on just one day before the OCL Period. Respondents lost money on the price spreads for those trades, and the per-trade MWh volume of those trades was far lower than it was during the OCL Period. And, unlike how they traded those paths during the OCL Period, the Respondents did none of their trades at BeckJord6 and Tanners Creek 3 during the HE10-22 period.

[57] Calculations in this table relied upon the following data and Enforcement determinations: Coaltrain's Transactional data (Bates Nos. COALTRAIN003512 – 3519), Energy Endeavors' Transactional data (Bates Nos. COALTRAIN004128–4134), and Coaltrain's OCL Transactions (Bates No. COALTRAIN011540). Data for the OCL Trades (highlighted in red) are from the transactions identified in COALTRAIN011540, such that false negatives are excluded and false positives are included (See supra 6-7). For instance, Rockport – Southwest includes false positive transactions, otherwise its paid transmission would be 100%.

- **Voluntarily Paying For Transmission:** For three of the paths (AK Steel-Southwest, Rockport-Southwest, and Beav Duq Unit1-MichFe) the Respondents used almost all free transmission before the OCL Period, and much more paid-for transmission in the OCL Period. Also, their per-trade MWh volume was much larger during the OCL Period than before.
- **Early OCL Trade:** The last of the paths (CPLEImp-DUKExp) appears to have been an early OCL trade. Respondents only traded on this path in the three days leading up to June 15. Since the path involved large-volume trades and the unnecessary purchase of transmission, it is likely that these were OCL Strategy trades as such (just done before Respondents started tagging its OCL Strategy trades). Those trades lost more than $17,000 (on spreads less charges) in just three days, but profited from MLSA payments.

Thus, while Coaltrain did place some trades on a handful of OCL paths before the manipulation began, that fact does not exonerate the Respondents. Far from it: there was a substantial difference between how they traded those paths as "spread" trades (smaller per-trade volumes, less concentration in HE 10-22, and using free transmission or overscheduling) before the OCL Period, and how they traded those same paths for the OCL Strategy (larger volumes, concentrating in the HE10-22 time when MLSA payments were highest, and voluntarily using paid transmission when it was not necessary to do so). Those differences represent the heart of the OCL Strategy, and show why those summer 2010 trades were part of the manipulative scheme.

The other 38 OCL paths were not as successful as SouthImp-Exp and NCMPAImp-Exp in achieving the goals of the OCL Strategy. But the fact remains that the Respondents themselves labeled them as part of the same strategy. As Wells repeatedly said in internal communications during August 2010, the potential profitability of those trades was measured by the MLSA that they anticipated would be paid. Respondents actually quote Wells making it clear that the loss credits were the reason to trade one of the 38 additional OCL trades: "OCL play - Load projected at 130K for tomorrow. Like days show *loss credits in the 1.7 range*. This guy takes a small hit on Wylie Xfmr and Mt Storm - Prunty yet with both of those in a lot this month it has still averaged a *positive 10 cents all month* On-Peak *aside from the loss credits*. Recommend

300MW, 10 - 22....."[58] That is, Wells saw 10 cents in spread revenues—far too little to pay transaction costs, and therefore wholly irrational as an arbitrage trade—but $1.70 in MLSA payments, making the trade very attractive as a vehicle for huge-volume trades (300 MWs each hour from HE10 to HE22) aimed at collecting MLSA. That is the heart of the OCL Strategy, and it is manipulative.[59]

**ii. <u>Respondents Could Reasonably Predict MLSA Payments</u>**

Respondents also contend (Ans. at 30-31, Lesser at PP 156-173), that the allegations in the Staff Report are disproved by the fact that MLSA payments themselves were volatile. They are mistaken. While MLSA payments did in fact vary quite substantially, Respondents knew that (a) MLSA would always be paid because the *marginal* loss collection was by definition larger than the *average* loss, and (b) the amount of money in the MLSA pool was directly related to the amount of losses in the system, which itself was derived from the size of demand, or load, because transmission losses increase as congestion increases. For instance, Respondents drafted a document

[58] Ans. at 38 (quoting Bates No. COALTRAIN011542, Vote-Comments tab row 6214 (emphasis added in Answer)).

[59] Lesser also addresses trades that Coaltrain made on the 38 OCL paths *after* the OCL Period ended. Lesser at PP226-230. Those trades are not relevant to this proceeding. First, as noted above, simply making trades on the OCL paths is not a *per se* violation. Second, the cost structure of UTC transactions changed drastically when the tariff was amended in September 2010. Those changes mean that the post-amendment trades are not comparable to the pre-amendment trades.

highlighting how the MLSA pool was figured:[60]

| | A | B | C | D | E | F | G | H | I | J | K | L |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | | | | | | | | | | | | |
| 2 | **DA Injection Credits** | | | | | | | **DA Withdrawal Charges** | | | | |
| 3 | | | | | | | | | | | | |
| 4 | cleared gen offers | | | | | | | cleared demand | | | | |
| 5 | cleared inc offers | | | | | | | cleared dec bids | | | | |
| 6 | DA energy purchases | | | | | | | DA energy sales | | | | |
| 7 | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | |
| 9 | **Balancing Injection Credits** | | | | | | | **Balancing Withdrawal Charges** | | | | |
| 10 | | | | | | | | | | | | |
| 11 | (RT gen + RT energy purchase) - | | | | | | | (RT load + RT energy sales) - | | | | |
| 12 | | (DA gen + DA inc's + DA energy purchase) | | | | | | | (DA demand + DA dec's +DA energy sales) | | | |
| 13 | | | | | | | | | | | | |
| 14 | | | | | | | | **Explicit Loss Charge** | | | | |
| 15 | | | | | | | | internal purchases | | | | |
| 16 | | | | | | | | import/export transactions | | | | |
| 17 | | | | | | | | | | | | |
| 18 | | | | | | | | | | | | |
| 19 | **Transmission Loss Credit** | | | | | | | | | | | |
| 20 | | | | | | | | | | | | |
| 21 | DA loss charges + Balancing loss charges | | | | | | | | | | | |
| 22 | | | | | | | | | | | | |
| 23 | prorated | | | | | | | | | | | |
| 24 | RT load + RT exports (that pay) + upto (that pay) / PJM load + exports + upto | | | | | | | | | | | |
| 25 | | | | | | | | | | | | |
| 26 | | | | | | | | | | | | |
| 27 | | | | | | | | | | | | |
| 28 | Loss factor increases with: | | | | | | | | | | | |
| 29 | | higher temps | | | | | | | | | | |
| 30 | | major line outage | | | | | | | | | | |
| 31 | | as lines become more overloaded | | | | | | | | | | |
| 32 | | | | | | | | | | | | |

Lesser emphasizes that MLSA payments could vary in size, and he misleadingly focuses on the fact that the MLSA payments were often less than 89 cents (which was the approximate cost per-MWh of trading UTCs using paid-for transmission). Lesser at P 162. But he ignores the fact that (as shown in the snapshot above) the Respondents figured out that the size of MLSA payments was related to the size of load, and they obviously knew that load is higher in summer months and during on-peak hours. For instance, as a spreadsheet apparently created by Sheehan indicates, Respondents knew

[60] Bates No. COALTRAIN009466.

that MLSA payments were higher during the summer, and during on-peak hours:[61]

| June | | | | | July | | | | | August | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | High | Low | Average | Median | | High | Low | Average | Median | | High | Low | Average | Median |
| HE1 | 0.8737 | 0.4487 | 0.7017 | 0.7134 | HE1 | 0.8906 | 0.5946 | 0.7586 | 0.7707 | HE1 | 0.9813 | 0.4872 | 0.6978 | 0.681 |
| HE2 | 0.8098 | 0.4014 | 0.6204 | 0.6227 | HE2 | 0.8408 | 0.5621 | 0.68 | 0.6819 | HE2 | 0.8579 | 0.4647 | 0.6337 | 0.6193 |
| HE3 | 0.7489 | 0.3447 | 0.5666 | 0.5722 | HE3 | 0.7229 | 0.4958 | 0.6183 | 0.6351 | HE3 | 0.807 | 0.3448 | 0.5519 | 0.5267 |
| HE4 | 0.7119 | 0.3125 | 0.5304 | 0.5484 | HE4 | 0.696 | 0.3953 | 0.5715 | 0.5873 | HE4 | 0.7855 | 0.3223 | 0.5114 | 0.5035 |
| HE5 | 0.7228 | 0.344 | 0.5284 | 0.5311 | HE5 | 0.7183 | 0.3502 | 0.5594 | 0.5792 | HE5 | 0.7625 | 0.3024 | 0.5033 | 0.4936 |
| HE6 | 0.7922 | 0.4128 | 0.5769 | 0.5796 | HE6 | 0.8409 | 0.3376 | 0.5975 | 0.5998 | HE6 | 0.8659 | 0.3 | 0.5524 | 0.5517 |
| HE7 | 0.8393 | 0.4095 | 0.6564 | 0.6823 | HE7 | 0.95 | 0.307 | 0.6645 | 0.6888 | HE7 | 0.9721 | 0.2955 | 0.636 | 0.6728 |
| HE8 | 0.9198 | 0.4931 | 0.7674 | 0.7889 | HE8 | 1.2058 | 0.5525 | 0.8551 | 0.8371 | HE8 | 1.0914 | 0.4075 | 0.7481 | 0.7869 |
| HE9 | 0.9737 | 0.6312 | 0.8352 | 0.8412 | HE9 | 1.373 | 0.6314 | 0.9639 | 0.9184 | HE9 | 1.229 | 0.5847 | 0.8385 | 0.848 |
| HE10 | 1.1027 | 0.7169 | 0.9087 | 0.9199 | HE10 | 1.573 | 0.7312 | 1.0621 | 1.0298 | HE10 | 1.5208 | 0.7177 | 0.9724 | 0.9471 |
| HE11 | 1.3296 | 0.792 | 1.0345 | 0.9942 | HE11 | 1.8538 | 0.7372 | 1.29 | 1.3302 | HE11 | 1.787 | 0.6907 | 1.1189 | 1.0398 |
| HE12 | 1.7727 | 0.8347 | 1.1858 | 1.1818 | HE12 | 2.1062 | 0.7423 | 1.463 | 1.4657 | HE12 | 2.1842 | 0.6599 | 1.2641 | 1.1603 |
| HE13 | 1.9389 | 0.8313 | 1.3273 | 1.2899 | HE13 | 2.6699 | 0.7426 | 1.6441 | 1.6542 | HE13 | 2.4267 | 0.1681 | 1.3585 | 1.2421 |
| HE14 | 2.2267 | 0.9077 | 1.4813 | 1.4514 | HE14 | 3.2771 | 0.8059 | 1.901 | 1.9399 | HE14 | 2.7053 | 0.7008 | 1.5619 | 1.4452 |
| HE15 | 2.6786 | 1.0026 | 1.653 | 1.6518 | HE15 | 3.8181 | 0.8616 | 2.1358 | 2.1402 | HE15 | 3.056 | 0.7441 | 1.7246 | 1.5603 |
| HE16 | 2.8 | 1.0385 | 1.7744 | 1.8128 | HE16 | 4.2407 | 0.9615 | 2.3347 | 2.3175 | HE16 | 3.3624 | 0.8634 | 1.8722 | 1.8047 |
| HE17 | 2.8932 | 1.0347 | 1.8087 | 1.8336 | HE17 | 4.2543 | 1.0624 | 2.436 | 2.4983 | HE17 | 3.5435 | 0.9256 | 1.9304 | 1.8246 |
| HE18 | 2.5912 | 0.9647 | 1.7253 | 1.7425 | HE18 | 3.809 | 0.9949 | 2.2279 | 2.2207 | HE18 | 3.302 | 0.8391 | 1.7815 | 1.6353 |
| HE19 | 2.1845 | 0.8585 | 1.4131 | 1.4358 | HE19 | 3.2619 | 0.8925 | 1.8163 | 1.862 | HE19 | 2.5297 | 0.7085 | 1.4326 | 1.3076 |
| HE20 | 1.8242 | 0.7749 | 1.2293 | 1.2194 | HE20 | 2.4294 | 0.7089 | 1.5135 | 1.5058 | HE20 | 2.091 | 0.7806 | 1.2706 | 1.1476 |
| HE21 | 1.5842 | 0.7578 | 1.1744 | 1.1371 | HE21 | 2.385 | 0.6894 | 1.4627 | 1.5081 | HE21 | 2.2556 | 0.4773 | 1.3469 | 1.2474 |
| HE22 | 1.4835 | 0.7159 | 1.0853 | 1.0847 | HE22 | 2.1086 | 0.6885 | 1.3489 | 1.3738 | HE22 | 1.8902 | 0.5172 | 1.1544 | 1.0368 |
| HE23 | 1.0921 | 0.6378 | 0.8542 | 0.8548 | HE23 | 1.3867 | 0.636 | 1.0525 | 1.0804 | HE23 | 1.2737 | 0.6512 | 0.911 | 0.8731 |
| HE24 | 0.8849 | 0.5759 | 0.7442 | 0.7688 | HE24 | 1.041 | 0.557 | 0.8463 | 0.8616 | HE24 | 1.0411 | 0.5496 | 0.8036 | 0.7711 |
| | | | 1.049288 | | | | atc | 1.283483 | | | | | 1.090696 | |
| | | | | | | | onpeak | 1.594219 | | | | | | |
| | | | | | | | offpeak | 0.662013 | | | | | | |

Looking at the data for MLSA during the peak hours, when MLSA payments were highest ($1.59 versus 66 cents off-peak—*see* the bottom middle of the snapshot above), it is apparent that Lesser's Table 2 (Lesser at P 161) creates a misleading picture. Reproducing Lesser's table to look at the hours when Respondents concentrated 97% of their OCL trades by volume shows that the average MLSA payment was higher during the 10-22 hours, and far fewer of the MLSA payments during those hours were below 89 cents:[62]

[61] Bates No. COALTRAIN009468 (Loss Credit Analysis tab).

[62] 04.5-DR4-Simulated Loss Credit Rate by type Aug2008-Sept16-2010.xls. The HE-10-22 results during the summer months from 2008-10 show that the amount of MLSA paid in those times was less than 67 cents only 2% of the time; this means that MLSA payments covered the cost of non-firm transmission during the day 98% of the time in the summer.

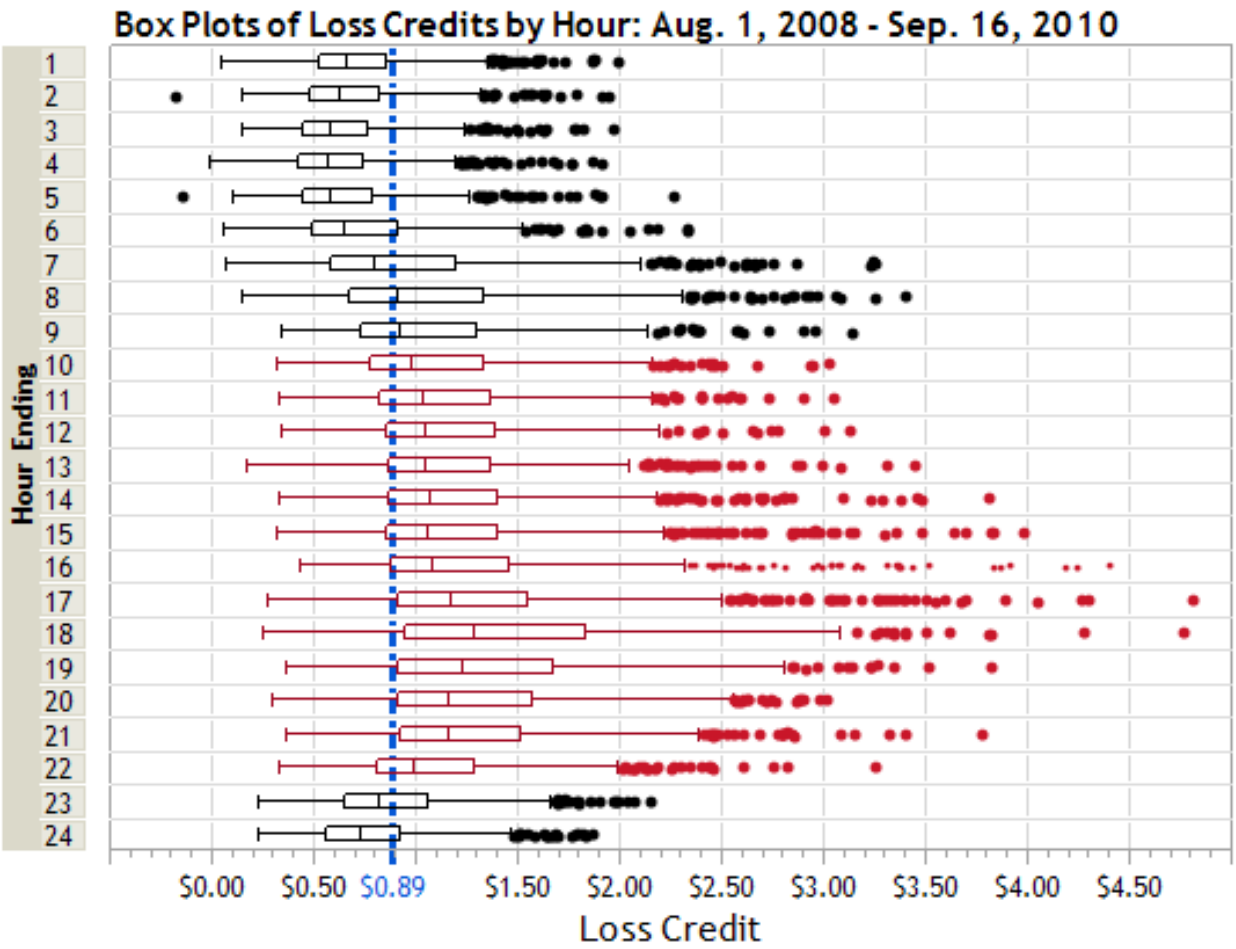
**Reproduction of Lesser Table 2:**
**Loss Credits, August 1, 2008 - September 16, 2010**
**Hours Ending 10-22 vs. Other Hours**

| Item | HE 10-22 | HE 1-9, 23-24 |
|---|---|---|
| Maximum Value | $4.81 | $3.40 |
| Minimum Value | $0.17 | ($0.18) |
| Average Value | $1.23 | $0.79 |
| Percent of Hours Loss Credit < 89 cents | 28% | 70% |
| Std. Deviation (volatility) | $0.53 | $0.39 |
| Coefficient of variation | 43% | 49% |

In addition, because even these numbers include shoulder seasons, they understate average summertime MLSA payments HE 10-22 and overstate the proportion of hours in the summertime HE 10-22 when payments were below 89 cents:

Lesser says that MLSA payments were highly volatile. *See* Lesser at Figure 11. But that is misleading, because the direction of the volatility in the on-peak hours (when Coaltrain did most of its OCL trading) was primarily upward. That means that the volatility of on-peak MLSA payments mostly *increased* the size of those payments. In the chart that follows, the box represents the interquartile range (25 percent to 75 percent), and the lines represent 1.5 times the interquartile range, and the dots on the left and right edges indicate outliers. The blue dotted line indicates the 89-cent threshold. As can be seen, this chart further proves what Coaltrain knew: that MLSA payments were highest in the day, and lowest at night:[63]

[63] 04.5-DR4-Simulated Loss Credit Rate by type Aug2008-Sept16-2010.xls .




Additional evidence shows that the Respondents knew that anticipated load correlated to anticipated MLSA payments, and therefore that times when load was expected to be high (such as during a hot summer day) would correlate to larger MLSA payments. For instance, the Staff Report quoted Peter Jones writing that "average on peak losses have been around a bit above [$]1.50 (depending upon month) and I would expect June losses to be up a bit given higher loads."[64] Similarly, when Robert Jones first proposed NCMPAImp-Exp, he suggested that they try a "meg tester for a high load/high loss credit day."[65] As noted above, Respondents themselves quote Wells saying "OCL play - Load projected at 130K for tomorrow."[66] Thus, while the size of

[64] Staff Report at 27 (quoting Miller Spector 360 Chat IM (June 10, 2010 8:48 a.m.).

[65] Staff Report at 51 (quoting R. Jones Test. Ex. CT-RJ 126).

[66] Ans. at 38 (quoting Bates No. COALTRAIN011542, Vote-Comments tab row 6214).

MLSA payments could and did vary, it followed a well-understood formula and Respondents were able to analyze and predict (and act on) what MLSA payments would likely be in the following day. For instance, Wells noted in late August that MLSA payments were expected to be about $1.70 for the next day,[67] and Robert Jones stated that "… So far this month the best hours for losses are 12-22 for an average of $1.38 in losses."[68]

Accordingly, while MLSA payments could and did vary in size, the Respondents figured out that the payments were highest in on-peak hours during the summer (when load is highest). And, not coincidentally, they made almost all of their OCL trades during those same high-MLSA hours—more than 97% of the OCL trades by volume were done HE 10-22, when load (and MLSA) was highest. Far from exculpating their trading strategy, the evidence that MLSA payments varied in amount further proves that the sole purpose of their OCL Strategy was to profit from MLSA payments.

#### iii. <u>That OCL Strategy Trades Carried Some Transaction Risk is Not a Defense</u>

Respondents also contend (Ans. at 31-32) that all of their UTC transactions (including the OCL Strategy trades) carried some transaction risk—particularly the risk that the trade would not clear, leaving them to pay for transmission without incurring any MLSA gain. That is true to some extent: there is no such thing as a UTC trade with zero risk of not clearing. The Staff Report in fact highlighted this fact in the June 10 IM conversation between Sheehan and Miller:[69]

- **Carlog33**> what price would we expect to make money on for OCLs
- **Carlog33**> pete suggested same prices
- **shawnconectiv**>well the risk is that you if you don't get done [i.e. cleared] you have just paid .67 for trans for nothing
- **Carlog33**> thats true

[67] Staff Report at 55 (citing Wells Spector 360 Snapshot No. 75061 (Aug. 30, 2010 8:30:24 a.m.)).

[68] Staff Report at 87 (quoting Bates No. COALTRAIN011542, Votes-Comments tab row 2646).

[69] Staff Report at 27 (quoting Miller Spector 360 Chat IM (June 10, 2010 9:34 am)).

But the mere fact that there is some irreducible risk to a transaction does not transform it from a manipulative into a legitimate act. In any event, the Day-Ahead bid prices selected by the Respondents ensured that nearly every single OCL Strategy bid cleared the market, in stark contrast to their spread trades. As the Staff Report indicates, Respondents cleared 100% of their SouthImp-Exp bids, 100% of the NCMPAImp-Exp bids, and 97% of the bid volume they submitted on the 38 other OCL paths, whereas they cleared only 78% of the volume they bid on their Spread Strategy trades during that same summer.[70] This materially higher clearance rate for OCL trades shows that the Respondents were willing and able to select bid prices to ensure that their OCL trades cleared (a rational maneuver, considering that Sheehan did not want to "pa[y] .67 for trans for nothing"), whereas their Spread Strategy trades failed to clear at the same rate due to some combination of price-sensitivity on the part of the Respondents and price volatility on the part of the trades themselves. In short, Respondents are correct that their OCL trades carried some transaction risk, but that fact does not mean that their OCL Strategy trades were lawful, and the differing clearance rates between the OCL and Spread trades actually further proves that the OCL trades were manipulative.

#### iv. Whether Some of The OCL Strategy Trades Were Hedged Is Immaterial

Respondents also argue (Ans. at 32) that they executed other trades to hedge against risks in its OCL trades, and that this fact exonerates them. That is incorrect. First, Respondents point to a handful of instances when statements were made in contemporaneous documents concerning hedging, but the fact that Respondents were concerned that a particular OCL bid might not clear or might have an adverse price spike is not evidence that they were entering the trades to arbitrage prices. It is not inconsistent with trading to profit from MLSA payments to hedge against the possibility that market conditions might cause a price spread, particularly in light of the enormous volumes Respondents put at risk on those trades and the fact that these hedging statements were

[70] *See* tables in Staff Report at 80, 84, and 88-89.

made relatively early in the OCL Strategy period (*i.e.* between mid-June and early July, long before the OCL Strategy ended in early September).

Furthermore, these references to hedging ignore the fact that the Respondents also associated OCL trades with fake constraints. As discussed in the Staff Report (at 90-91), Respondents used a type of analysis that focused on the ways in which so-called "constraints" in the system affected prices. Their applications were set up in a way that required them to associate specific constraints with specific trades they were proposing to do. Thus, when doing their "Spread Strategy" trades, they would decide which trades to make by looking for constraints that caused the trades to make a profit, and then they would decide whether to do the trade based on their prediction about which constraints would be in effect the next day. But the story was different for their OCL Strategy trades. For many of those trades, rather than assigning a real constraint to a particular path in determining whether the trade would make a profit (from price spreads), they typically relied on completely fictional constraints (including one they called "PJM OCL") when proposing to do OCL Strategy trades. They even described in their internal correspondence some of these fictional constraints as "[n]ot a true constraint, this was selected for the Export OCL plays which all go to OVEC."[71] If their OCL trades were aimed at profiting from price spreads, then it would have made no sense to use fake constraints to justify such trades.

**b. <u>The Purpose of the OCL Strategy Was "OCL"</u>**

Next, Respondents contend (Ans. at 33-36) that their OCL Strategy trades were not made for the purpose of collecting MLSA. In particular, they claim that (1) their considering "all costs and credits of a trade" was "economically rational" (Ans. at 33-35); and (2) their strategy was consistent with Commission precedent (Ans. at 35-36). Respondents are wrong.

Respondents contend that it was rational to take MLSA payments into consideration when deciding whether to make UTC trades because, according to Lesser's

[71] Bates No. COALTRAIN000310 Question 4 Document 1, row 7539.

legal analysis, "'economically rational UTC traders would attempt to forecast the expected net benefits of a trade, based on the DA-RT price spreads and loss credits before entering into a trade.'"[72] But MLSA payments cannot be the sole or primary reason for making UTC trades. As the Commission has explained: "MLSA payments were not, and should not be considered, part of the underlying UTC trade."[73] Speculative arbitrage trades "placed to arbitrage price spreads will have as their sole or primary price signal the price risk of the underlying UTC spread and will be placed with the purpose of profiting based on the direction of the spread."[74] By contrast, Respondents here appear to be conceding that the MLSA payments were (to put it mildly) a key consideration in their decision to make the OCL Strategy trades. While the Respondents argue that their OCL Strategy trades did not have as their *primary* purpose the collection of MLSA payments, that contention is belied by the record. And in fact, those trades were very unprofitable—as Respondents expected—but for the MLSA payments. And, as in *City Power*, Respondents showed their hand by voluntarily *increasing* their transaction costs by willingly paying to reserve transmission, when the *only* reason to do so was to lay a claim on MLSA payments. By doing frequent, large-volume trades on paths that were uneconomic but for MLSA payments, and by paying for transmission unnecessarily to qualify for MLSA payments, Respondents plainly and expressly made the collection of MLSA payments the primary or sole purpose of their OCL trades.

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[72] Ans. at 33 (quoting Lesser at P 114). In Lesser's submission on behalf of the petitioners in the *Black Oak* proceeding (including Energy Endeavors, which is Coaltrain's predecessor), he stated that not allowing virtual traders to receive MLSA payments would "distort market choices by allowing physical traders to engage in trades whose costs exceed their benefits." Request for Rehearing, Lesser Aff., *Black Oak Energy, LLC v. PJM Interconnection, Inc.*, Docket No. EL08-14-002, at ¶ 27 (Oct. 19, 2009). Lesser did not explain in that filing or elsewhere why virtual traders who "engage in trades whose costs exceed their benefits" are not also distorting the market.

[73] *Chen*, 151 FERC ¶ 61,179 at P 78; *City Power*, 152 FERC ¶ 61,012 at PP 139, 158.

[74] *City Power*, 152 FERC ¶ 61,012 at P 139.

Respondents also contend (Ans. at 35-36) that the legal question here is resolved by the Commission's order in the *Lake Erie Loop Flow* proceeding.[75] The Commission already rejected the same contention in the *City Power* decision, stating that in *Loop Flow* the "transactions were executed to lower market participants' costs based on market fundamentals for transactions they already sought to engage in, and were not "'created by any intentional actions of market participants to obstruct an otherwise well-functioning market.'"[76] By contrast, the trading here, as in *City Power* and *Chen*, was "devoid of economic substance."[77] Respondents also cite *Blumenthal v. ISO New England, Inc.*,[78] but as the Commission held in *City Power*, that order's reference to "rational economic behavior" in the face of inconsistent scheduling requirements differs significantly from the MLSA-targeting trades that the Respondents employed here.

#### c. <u>Respondents' OCL Strategy Trades Were Not Driven by Market Fundamentals</u>

Finally, Respondents claim (Ans. at 37-52) that their OCL Strategy trades were based on market fundamentals, not MLSA payments because (1) they analyzed market fundamentals before executing UTC trades (Ans. at 37-40); (2) the Staff Report supposedly mischaracterizes the record (Ans. at 40-51); and (3) voluntarily paying for transmission when it was necessary to do so was "economically rational and contemplated by the tariff" (Ans. 51-52). There is no merit to any of these claims.

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[75] *New York Independent System Operator, Inc.*, 128 FERC ¶ 61,049 (2009) (*Lake Erie Loop Flow*). Respondents also cite the settlement agreements in *MISO Virtual Trading and FTR Trading*, 146 FERC ¶ 61,072 (2014), and *Deutsche Bank Energy Trading, LLC*, 142 FERC ¶ 61,056 (2013) for the proposition that traders must take into account "all" factors affecting profitability. This argument misconstrues the discussion in those matters. As the Commission addressed in the *City Power* and *Chen* orders, MLSA was *not* part of the UTC transaction, unlike the RSG charges in *MISO* and the transmission charges in *Deutsche Bank* which made the trades in those matters uneconomic.

[76] *City Power*, 152 FERC ¶ 61,012 at P 104 (quoting *Lake Erie Loop Flow*, 128 FERC ¶ 61,049, App. A at 26).

[77] *City Power*, 152 FERC ¶ 61,012 at P 104.

[78] 135 FERC ¶ 61,117 (2010) (incorrectly cited by Respondents as 132 FERC ¶ 61,017 (2010)).

First, the essential issue for the Commission is not whether the Respondents performed any fundamentals-based analysis before executing OCL Strategy trades (which they *had* to do to ensure they would fit with the OCL Strategy), but whether they made the OCL Strategy trades to *profit* from market fundamentals. The evidence overwhelmingly shows that they did not. Since the OCL Strategy trades did involve some irreducible transaction risk (as discussed above), and since it turns out that it was not easy to discover trades that reliably succeeded under the OCL Strategy, the Respondents obviously needed to do some analysis of the fundamentals before making their OCL Strategy trades, but that does not mean the trades were designed to profit from the fundamentals.

Respondents contend (Ans. at 37) that "[t]he purpose of the [OCL Strategy] label was merely to designate that the trade was *eligible* for MLSA credits." That is untrue. Far from what Respondents suggest, the OCL Strategy was not merely a moniker applied to trades that were eligible for MLSA payments; it was a term applied to a type of trade that relied on anticipated MLSA payments to achieve profitability. Indeed, Coaltrain effectively conceded this when in a communication with Enforcement it defined the OCL Strategy as "a trade that settlement considerations had the potential to make profitable if a dynamic constraint did not make it profitable on its own."[79] (Stated plainly: trades likely to make money on MLSA regardless of the outcome on the merits.)

Even the Respondents themselves do not buy their own contention: as they concede in a footnote, it was "not entirely accurate" to say that the label referred only to MLSA-eligible trades "because some of the trades labeled as 'Spread' trades were in fact eligible for MLSA." Ans. at 37 n.158. If the OCL Strategy was intended merely to refer to the MLSA eligibility of a trade, that does not explain why Wells repeatedly wrote such things as "#3 Import this morning behind NCMP & Southimp/Exp"[80] and "Next best

[79] Staff Report at 19 (quoting Coaltrain Resp. to Question 15 of Third Data Request (May 25, 2012)).

[80] Staff Report at 87 (quoting Bates No. COALTRAIN011542, Votes-Comments tab row 5070).

**OCL play** behind Marquis and Stuart 1-4, all source at OVEC. Miami Fort 7 & 8 price the same. **OCL Play**….”[81]

Yet MLSA was paid on a *pro rata* basis across all eligible MWhs, which means that SouthImp-Exp and NCMPAImp-Exp were not going to receive more MLSA per MWh than any other trade using paid-for transmission. Plainly, what made those trades so good was not how much MLSA they would receive, but how negligible the price spread would be. This and other evidence demonstrate that the OCL Strategy was not just a reference to MLSA eligibility, but rather to an entirely different type of trading, one that relied on MLSA payments, not spread changes, to achieve profitability. Indeed, as Wells later testified, Coaltrain placed OCL trades even when it expected price spreads to be negative, and achieved a net profit only because of MLSA.[82] The fact that some of the Respondents did not concede these unavoidable facts when they testified (after their scheme had come to light) does not rebut what the contemporaneous documentary evidence tells us: that the OCL Strategy was designed to profit from MLSA payments and not from changes in price spreads.

Respondents also contend that the Staff Report inaccurately states that Wells did not perform fundamentals-based research before making more than a hundred thousand MWh of OCL Strategy trades early one morning. Ans. at 40-51, Jones Ans. at 12-14. They argue that, because transmission reservations could not be submitted before 8 a.m., Wells did in fact perform fundamentals-based research before he submitted the trades to PJM. But this misses the point of this evidence: the issue is not when the trades were actually executed, it is whether Wells thought it necessary to perform any meaningful research before setting up large volumes of OCL trades. The screenshots show (at Appendix A) that he did not, and this fact highlights the difference between Coaltrain’s spread trades (which it placed in much smaller volumes, and scheduled later in the morning after performing substantial research) and its OCL trades (which Coaltrain

[81] Staff Report at 87 (quoting Bates No. COALTRAIN011542,Votes-Comments tab row 5069) (emphasis added).

[82] Staff Report at 87 (citing Wells Test. Tr. 142:13-143:8; Wells Test. Ex. 49).

submitted in enormous volumes, but—as the screenshots indicate—were set up as a quick part of the morning routine).[83]

For instance, on July 7, 2010, Wells turned on his monitors at 6:48:48 a.m., and over the course of the next *three minutes* entered 137,800 MWh of OCL trades in Coaltrain's Market Interface application, which served as a buffer to store transactions before the PJM market opened. *See* Appendix A. That Wells could not submit these transactions to PJM until 8 a.m. is irrelevant: three minutes into his day, Wells did as much as he could do (before the market opened) to get the trades ready to go.

Respondents point to two items that, they contend, show that Wells did research before setting up those trades: the Outage Viewer (at 6:49 a.m.) and the "Copy Curves" application. Ans. at 43. But neither helps them. The Outage Viewer was actually just an application that Wells had left open when his monitors turned off the previous day. *See* Appendix A (Screenshots 1 and 2). Meanwhile, Wells's use of the "Copy Curves" application actually shows, as Respondents concede, that he copied an OCL trade "from [the] previous day" (Ans. at 43) into the firm's Market Interface tool, and thus was simply repeating the previous day's trades. In fact, the screenshots cited by Respondents show that Wells did not begin doing any meaningful research until *after* he had entered the OCL trades into the Market Interface tool. And it is noteworthy that when Wells finally was able to reserve transmission for the OCL trades, he used "Pre-Confirmed" transmission which, under the Commission's rules, gave his reservation request priority over competing requests that did not involve Pre-Confirmed transmission.[84] Thus, the evidence from the screenshots demonstrates that Wells felt confident enough about the

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[83] While the fact of having done research is not a *per se* barrier to a finding of manipulation—indeed, many manipulative schemes require substantial research in order to succeed, and Respondents certainly engaged in a lot of research to perfect the OCL scheme—the absence of research before setting up such a large volume of trades is evidence that the trader did not think the transaction was an arbitrage trade requiring careful study of then-current conditions.

[84] *See* OASIS Logon, Wells Screenshot 42990, July 7, 2010, 8:07:10 a.m. (pre-confirmed transmission). "Pre-confirmed" transmission requests are given a higher priority than normal transmission requests. *Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, FERC Stats. & Regs. ¶ 31,241, at P 1403 (2007).

OCL trades that he entered 137,800 MWh of the trades into the firm's trading tool (ready to be submitted to PJM as soon as the market opened) within three minutes of arriving at the office, before he performed any meaningful research.

Respondents also argue (Ans. at 45) that the Staff Report incorrectly characterizes Wells's testimony when he says that certain trading analyses were "almost exactly the opposite of a normal analysis."[85] Respondents state (Ans. at 45) that Wells was testifying only about "his view of the differences between trades based on primary and secondary constraints in the system." In fact, Wells was responding to a question about the fake PJM OCL constraint:

> Q: So how is a PJM OCL, how is that a secondary constraint?
>
> A: It's kind of a misnomer. The constraints in general are written to identify potential problems between two points. In this case, we've identified points that are returning some type of payout, more so than what it's costing to buy them. But we were doing so with a low-risk filter strategy run that was just showing us these points are paying. And it was almost exactly the opposite of a normal analysis where I said these guys are shutting this plant down, these guys are taking this transmission line out of service, these guys are doing whatever, so I think I'm going to have a problem between these points. In this case I have no idea what's causing that problem. All I can see is there's a consistent payout between these points. I don't know why.[86]

What this testimony shows is that there was a sharp distinction between "primary" and "secondary" constraints, and that the analysis for secondary constraints like "PJM OCL"—used for OCL Strategy trades—was "almost exactly the opposite of a normal analysis." And, since the Respondents used secondary constraints (including "PJM OCL") to tag their OCL trades, the OCL analysis followed the secondary constraint analysis.

Respondents state (Ans. at 47-48) that the reason Peter Jones testified that the SouthImp-Exp trades were "economically feasible" was because of the "predicted constraint." They even quote his preceding testimony that discussed constraints that they

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[85] *See* Wells Test. Tr. 100:23-25.

[86] Wells Test. Tr. 100:14-101:5.

thought had affected prices on that path in the past. But the fact is that, in response to the question "[w]hat made it economically feasible" in light of the fact that the path settled at zero day after day when they traded it, Jones responded "[t]he cost of the trade and, you know, the fact that the market settlement charges and credits have the potential to balance each other out."[87] Stated more plainly, Jones is saying that MLSA payments are likely to exceed transaction costs, even with no spread changes. That is why Coaltrain continued to make enormous volumes of trades on the SouthImp-Exp path every day, despite never once experiencing a positive (or negative) spread, because MLSA made it "economically feasible."

Finally, Respondents argue (Ans. at 51-52) that the decision to pay for transmission was economically rational and contemplated by the tariff. That is incorrect. As the Commission held in *City Power*, MLSA payments are not part of the UTC transaction, and choosing to pay for transmission when free transmission was available is evidence of manipulation.[88] Respondents try to justify their choices by comparing MLSA to grocery store coupons, and that it was appropriate for them to take MLSA payments into consideration when making their trades. Ans. at 52. But MLSA was not a discount or reduction of the price like a coupon, and it was not part of the UTC trade. Respondents manipulated the market not because they were simply *aware* of MLSA payments (as any experienced trader would have been), but because they—unlike the vast majority of UTC traders—decided to make trades not for the lawful purpose of arbitrage but for the unlawful purpose of collecting MLSA payments.

### 4. <u>Respondents Acted With Scienter</u>

#### a. <u>Reasonable Inference From Their Conduct</u>

Respondents contend (Ans. at 81-83) that the Commission may not resolve questions of scienter when contested, and also (Ans. at 84-89) that the Staff Report does not include any evidence that "Respondents intended to deceive the market or artificially

[87] P. Jones Test. Vol. I Tr. 95:11-16.

[88] *See City Power*, 152 FERC ¶ 61,012 at PP 152, 156 (discussing choice to unnecessarily pay for transmission for NCMPAImp-Exp trades).

impact prices." As to the first issue, and discussed in greater detail below, the Commission plainly has authority—indeed, it has the duty—to determine whether a violation occurred before it can lawfully assess penalties. Since Respondents have elected *not* to have this matter adjudicated through an ALJ hearing, the Commission's role is to address factual questions during this order to show cause proceeding. And here, that task is easy: the record is replete with overwhelming proof that the Respondents knowingly made trades for the purpose of collecting MLSA, and they raise only a scintilla of evidence in attempted rebuttal.

As to the latter point, Respondents seek to apply the wrong standard. Scienter does not require direct proof; it may be proved by circumstantial evidence. In any event, there is plenty of proof—direct and circumstantial—cited in the Staff Report and included in the investigative record submitted to the Commission that the Respondents devised and executed a scheme to trade UTCs that profited not from market fundamentals (*i.e.* price spreads) but rather to divert MLSA from other market participants. They knew from the abundant trade data at their fingertips that the OCL Strategy trades—and particularly the "best" ones, SouthImp-Exp and NCMPAImp-Exp—were uneconomic but could nevertheless generate large profits because of MLSA. They knew that this was a categorically different type of trading from their arbitrage-based "Spread" strategy, which is why they gave it a different name (*i.e*. the "OCL" strategy to profit from MLSA, in contrast to the "Spread" strategy to profit from price spreads), and why they informed the Commission in a public filing that they would not engage in trades to capture a larger share of MLSA, noting that legitimate UTC trading involved profiting from the spread of Day Ahead and Real Time spreads. (This will be addressed in the next section.) They knew that the OCL Strategy trades targeted paths with relatively stable and small spreads. That is why Hughes wrote that he was looking to create an "application to find deals for

loss credits."[89] Put simply, the Respondents knew that the OCL Strategy targeted MLSA rather than arbitrage, and that satisfies the scienter element.

In their Answers, Respondents assert that they did not have scienter, but they do not point to any new evidence to substantiate this other than to continue to argue that the OCL Strategy trades sought positive price spreads and that it was in any event acceptable for them to "consider" MLSA payments in deciding which trades to make. But neither of these propositions is correct. As discussed above, there is substantial proof that the OCL Strategy trades specifically targeted OCL (*i.e.* MLSA payments). Such proof includes (1) analysis of the trade data, which shows that no rational trader would have thought that trading the way Coaltrain traded the OCL trades—huge volumes, insensitivity to prices, many hours per day every day—would lead to profits from price spreads; (2) the fact that they voluntarily increased their transaction costs by paying for transmission for no reason other than to make the trades eligible for MLSA payments, when they used far less paid transmission for their "spread" trades; and (3) nearly all (97%) of their OCL trades by volume were during the hours (HE 10-22) when MLSA payments were highest, in contrast to their "spread" trading. Even the name of their manipulative strategy—the "OCL" Strategy—demonstrates their intent to target OCL (*i.e.* MLSA), in contrast to their "Spread" Strategy targeting spreads.

#### b. By Submitting a Misleading Filing to the Commission in *Black Oak*, Respondents Show They Knew the OCL Strategy Was Wrongful

Respondents argue (Ans. at 61-63) that the filing submitted to the Commission by Coaltrain and other "Financial Marketers" did not contain misleading statements. As the Staff Report described it, Coaltrain ("jointly and severally" with a few other market participants, according to the document itself) submitted a filing to the Commission on June 9, 2010 which (in footnote 23) "assured the Commission that MLSA would not create 'perverse incentives' for virtual traders 'to engage in virtual transactions in order

[89] Staff Report at 2 (quoting Bates No. COALTRAIN012638, row 1951; *see also* Bates No. COALTRAIN012639, row 27).

to capture a larger share of the surplus.'"[90] Footnote 23 went on to say that, even with MLSA available to virtual transactions, "market participants will conduct virtual transactions when they think they can profit from the difference between the day ahead LMP and the realtime LMP they expect" and that the availability of MLSA payments would not "significantly alter this calculus."[91] The Staff Report alleged that this statement was misleading because Coaltrain was at that very time planning the OCL Strategy, which involved doing precisely what the submission told the Commission they would not do: conduct transactions aimed at MLSA, not at spread profits.[92] Respondents' lack of candor with the Commission about their intention to trade to collect MLSA is further evidence of scienter.

In their Answer, Respondents now argue that the statement in the June 9, 2010 filing was not misleading, for three reasons. Each of these excuses is erroneous.

First, they claim that "the [perverse incentives] footnote [23] addresses only pure virtual trades—the only transactions at issue in the context of that pleading—not UTCs." Ans. at 62. (By "pure virtuals," Respondents meant inc and dec trades.) They further state that "[t]he pleading expressly differentiates 'pure virtuals' from UTCs." Ans. at 62 n.260 (quoting in part June 2010 Filing at 3 n.4). They are in error.

Footnote 23—the "perverse incentive" footnote—discusses "virtual transactions," not "*purely* virtual transactions." And critically, "virtual transactions" is *a defined term* in the June 9, 2010 filing. In footnote 4 of that filing—the same footnote that they cite in their Answer for the proposition that the June 2010 Filing "expressly differentiates 'pure virtuals' from UTCs"—Coaltrain and others expressly declared that "[t]he term 'virtual transactions' as used herein *includes pure virtuals as well as Up-To congestion transactions.*"[93] The full text of footnote 4 is as follows:

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[90] Staff Report at 91 (quoting in part June 2010 Filing at 20 n.23).

[91] *Id.*

[92] Staff Report at 91-92.

[93] June 2010 Filing at 3 n.4 (emphasis added).

[4] The term "virtual transactions" as used herein includes pure virtuals as well as Up-To congestion transactions. Although Up-To congestion transactions require an actual transmission system reservation and charge, no physical energy flows over the transmission system.

Footnote 4 thus specifically defined what the term "virtual transactions" meant in that filing, and that the term included *both* "pure virtuals" *and* UTCs. This flatly contradicts their contention here (Ans. at 62) that "the [perverse incentive] footnote [23] addresses only pure virtual trades—the only transactions at issue in the context of that pleading—not UTCs." Respondents' citation of Footnote 4 to support their position is inexplicable, because that footnote directly contradicts their entire argument. Read together, Footnote 4 and Footnote 23 in the June 9, 2010 filing show that Coaltrain assured the Commission that MLSA would not give them "perverse incentives" to make either "pure virtual" (inc or dec) *or* UTC trades "to capture a larger share of the surplus" and that they would continue to place only "pure virtual" *and* UTC trades aimed at arbitrage.

Next, Respondents contend that the "footnote is not addressing the effects on MLSA credits on virtual trading generally" but rather "it is contrasting two particular MLSA allocation methods for pure virtual trades …" Ans. at 63. But, as addressed above and in contrast to what the Respondents contend, the footnote *was* addressing the effects of MLSA on all virtual trading, including UTCs.

Finally, Respondents state that the "footnote plainly acknowledges that traders *will* consider MLSA credits in trading decisions" because it "predicts that differences in the allocation method will not 'significantly alter the trading calculus' and that price difference will continue to drive trading decisions—just as was true in Coaltrain's UTC trades." Ans. at 63. But as shown above, MLSA massively changed Coaltrain's trading calculus, leading it to place enormous volumes of trades that were wholly irrational as arbitrage trades. Put simply, the June 2010 Filing falsely reassured the Commission that it would not do something that it was in fact then planning to do, reflecting Respondents' awareness that their OCL Strategy plans needed to be concealed from the Commission.

### 5. <u>The OCL Strategy Harmed the Market</u>

Respondents also contend (Ans. at 63-67, Lesser at PP 231-242) that the OCL Strategy did not cause any market harm. As detailed at length in the Staff Report (at 111-117), Respondents' manipulative scheme did in fact harm the market by depriving other market participants of MLSA payments they would have received absent the OCL Strategy trades, and also by depleting available transmission capacity in the Day Ahead market, thereby possibly crowding out other market participants who needed to reserve non-firm available transmission capacity to do their own physical and virtual trades. Against this, Respondents make three arguments. None of them succeeds.

First, Respondents contend that the OCL Strategy did not cause any harm to other recipients of MLSA because no one had a right to any particular share of MLSA, and because, as Lesser argues, this "claim depends on a *but for* construction" that "assumes all market outcomes would have been identical but for Coaltrain's activities." Ans. at 64. But the Commission has already determined that market participants were in fact harmed by the diversion of MLSA payments to manipulative UTC trades.[94] Meanwhile, the "but for" argument reflects a fundamental misunderstanding of how MLSA works. Lesser appears to think that PJM would have to rerun the market to determine MLSA distribution, but that is not correct. In fact, MLSA simply reflects the surplus of loss payments collected by PJM that have to be redistributed. The UTC trades here paid relatively little money *into* the loss pool, so the size of the MLSA pool would not have been materially affected if Coaltrain's OCL trades were removed from it. On the other hand, MLSA is distributed on an equal basis per-MWh for a given hour. Therefore, removing Coaltrain's OCL trades from the loss *surplus* pool means that there would have been more money to distribute to the remaining market participants. That is what PJM calculated, and what is cited in the Staff Report (at 111-112).

Lesser states in his report (at P 236) that "the PJM analysis OE requested shows that $714,765 of MLSA payments would have gone to Powhatan Energy Fund LLC, HEEP Fund LLC, Inc. and CU Fund, Inc." While that is correct, it reflects the

[94] *See City Power*, 152 FERC ¶ 61,012 at P 235.

preliminary nature of PJM's analysis. In calculating diverted MLSA with regard to *Coaltrain's* behavior, PJM only removed *Coaltrain's* OCL Strategy trades from the market; it did not in that same analysis also remove the trades that the Commission found to be manipulative in *Chen* and *City Power*. And it performed the same task with respect to each of those companies. Accordingly, the preliminary analysis for Coaltrain shows that some of the money that Coaltrain's OCL trades took out of the loss pool would have been distributed to Chen and City Power; the analysis in *City Power* shows that some of the money that City Power's manipulative trades took out of the loss pool would have been distributed to Coaltrain's MLSA-eligible trades, and so forth. Once there is a final judgment in these matters, PJM can perform an analysis that removes all of the manipulative trades from the market, redistributing all of the diverted MLSA to eligible (legitimate) trades. To be sure, some of the MLSA payments unlawfully diverted by other parties would have been distributed to Coaltrain's *legitimate* UTC trades (just as the respondents in *City Power* and *Chen* lost some MLSA payments for their legitimate MLSA-eligible trades because of Coaltrain's scheme). Since most of Coaltrain's MLSA-eligible volume came from the OCL trades, however, it follows that Coaltrain's actual injury for the Chen and City Power schemes was much smaller than the $429,726 figure that Lesser cites when PJM is able to perform a final set of calculations. Contrary to what Lesser says, the fact that PJM's analysis was preliminary does not make it (or Enforcement's request to PJM) inaccurate.

Next, Respondents claim (at 65-67, Lesser at PP 237-242) that they did not deprive market participants of available transmission capacity when they reserved enormous volumes of transmission to effectuate their volume-based OCL Strategy. First, Respondents argue (at 65) that their UTC trades "were financial and, therefore, could not change real-time market demand or impact transmission or generation." That is only partially correct. UTCs affect Day Ahead prices, as they are integrated into the Day-Ahead pricing model. Second, Respondents state (at 65-66) that they did not deprive other market participants of transmission capacity because "they did not in fact consume transmission service" and because PJM periodically replenishes ATC. But that

misunderstands the marketplace. If insufficient transmission capacity is available in the Day Ahead market at a given time, a physical market participant cannot then schedule their transaction in the Day Ahead market (and another UTC trader could not trade at all). Moreover, while PJM does in fact replenish Day Ahead ATC that is not associated with Real Time flows (as stated in the Staff Report), such replenishment does not occur immediately. Rather, to pick up where the Staff Report's description left off (at 112-114), Day Ahead ATC is replenished first around 10:30 am, and once again around 11:30 am, and is always available on a first-come, first-served basis. For example, if a market participant discovers that no ATC is available on a particular path at 8:30 am, that trader cannot schedule his trade until he first obtains the ATC. Thus he must wait until 10:30 to try to reserve ATC when PJM re-releases it. If that market participant did not quickly reserve the ATC when it re-appeared, it might disappear again (something that often happened during the summer of 2010), and the trader would have no choice but to wait until 11:30 to schedule the trade. And if the trader missed the re-release at 11:30, the trade could not be scheduled in the Day Ahead market at all because PJM would not re-release the ATC again before the Day Ahead market closed at noon.

Notably, Wells sometimes requested "pre-confirmed" transmission.[95] "Pre-confirmed" transmission requests are given a higher priority than normal transmission requests. By requesting "pre-confirmed" transmission, the Respondents gave themselves an advantage in obtaining sufficient ATC to schedule their trades. While this would not itself be problematic if they were making those requests for a legitimate purpose, the fact that Respondents were giving themselves an advantage (and thus putting other market participants at a disadvantage) to secure sufficient ATC to schedule their manipulative OCL trades is yet another harm to the market.

In short, the Staff Report is correct that the Respondents caused two types of market harm by pursuing their manipulative OCL Strategy: diversion of MLSA payments and interference with transmission reservations.

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[95] *See* OASIS Logon, Wells Screenshot 42990, July 7, 2010, 8:07:10 a.m. (pre-confirmed transmission); Order No. 890, FERC Stats. & Regs. ¶ 31,241 at P 1403.

### 6. The Individual Respondents Are Liable as Primary Violators

Respondents contend (Sheehan Ans. at 14-21), that some of the individuals—particularly Sheehan, Miller, and Hughes—were not primary actors and cannot be held liable as secondary actors for their role in the manipulative scheme. To the contrary, as the Staff Report made clear, each of the named individuals directly participated in a coordinated fraudulent scheme, rendering each trader a primary violator of the Commission's Anti-Manipulation Rule. Staff's conclusions and liability theory against the individual traders is consistent with, and supported by, the Commission's rules and federal case law.

Order No. 670 clearly contemplates that group conduct can violate 1c.2. Not only does Order No. 670 prohibit fraudulent "scheme[s]," which, as discussed below, courts have held to include coordinated activity, but Order No. 670 also provides that market participants who engage in "conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market"[96] and "collusion for the purpose of market manipulation" violate the Anti-Manipulation Rule.[97] Each of the named individuals participated in a joint fraudulent scheme—each had individual knowledge of the scheme and each individually engaged in acts in its furtherance—and therefore each is a primary violator of the Anti-Manipulation Rule. The Staff Report does not rely on "controlling person," "aiding and abetting," or "secondary actor" liability, so Respondents' discussion of these concepts (Sheehan Ans. 14-21) is irrelevant.

Courts have recognized that those who participate in fraudulent schemes under SEC Rule 10b-5 by knowingly committing manipulative acts in furtherance of the schemes are primary violators.[98] In *Cooper v. Pickett*,[99] the Ninth Circuit summarily

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[96] Order No. 670, FERC Stats. & Regs. ¶ 31,202 at P 50.

[97] *Id*. P 59.

[98] *See, e.g.*, *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 111 (2d Cir. 1998) ("We have noted further that a primary violator is one who 'participated in the fraudulent scheme' or other activity proscribed by the securities laws") (quoting *SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1471 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1997)).

rejected defendants' attempt to use *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[100] to avoid liability for participating in a fraudulent scheme, noting that the complaint "does not allege a conspiracy . . . as a separate cause of action," but "[i]nstead … alleges a 'scheme' in which [the defendants] participated, tracking the language of [SEC] Rule 10b-5(a), which makes it unlawful for any person '[t]o employ any device, *scheme*, or artifice to defraud.'"[101] The court held that "*Central Bank* does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme."[102]

Respondents cite several court decisions which do not bear on, much less cast doubt on, the Staff Report's conclusions and theory of liability. In *Central Bank*, the issue before the Court was whether private civil liability under Securities Exchange Act Section 10(b) extends to those who "aid and abet the violation" but do not themselves "engage in the manipulative or deceptive practice."[103] In *Central Bank*, respondents "concede[d] that Central Bank did not commit a manipulative or deceptive act within the meaning of [Section] 10(b)" but sought to hold Central Bank "secondarily liable" for aiding and abetting.[104] The Court concluded that the statute imposes liability only on primary violators, *i.e*., those who commit manipulative or deceptive acts.[105]

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[99] *Cooper v. Picket*, 137 F.3d 616, 624 (9th Cir. 1997) (applying the lower pleading standards in effect before the PSLRA was in force).

[100] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

[101] *Cooper v. Picket*, 137 F.3d 616, 624 (9th Cir. 1997).

[102] *Id*.

[103] *Central Bank*, 511 U.S. at 167. In *Central Bank*, the allegation was that the bank serving as indenture trustee on a bond issuance had failed adequately to represent the interests of the bondholders by not requiring an updated appraisal of the property underlying the bonds. *Id*. at 167-68. The question was thus whether the indenture trustee breached its fiduciary duty, not whether it participated in a fraudulent scheme, as is the case here. *Id*.

[104] *Id*. at 191.

[105] *Id*.

The *Central Bank* question—whether those who do not engage in manipulative or deceptive practices may be found to have violated SEC Rule 10b-5—does not bear on the individual Respondents' liability here. The individuals engaged in a coordinated scheme to research and execute the OCL Strategy to avoid price arbitrage and profit from the volumetric collection of MLSA payments. Each of the individuals played a key role in that scheme. Miller and Sheehan were instrumental in formulating and devising the strategy in early June, Sheehan executed some of the trades (before Coaltrain had systems in place to specifically tag trades as OCL or Spread), and Miller coordinated with Wells and others to ensure that the OCL trades were executed. Hughes played an especially important role in the process, performing the research to help Respondents identify prospective OCL trades, and making or coordinating revisions to the company's software to assist in researching and executing OCL trades, as well as to help the firm better measure the strategy's profitability. Meanwhile, Peter Jones, Robert Jones, and Jack Wells each researched and executed the OCL trades in large volumes. Thus they each individually committed manipulative acts in furtherance of the coordinated scheme. Because they each participated in the coordinated scheme, the traders are each primary violators of the Commission's Anti-Manipulation Rule. For the same set of reasons, the court decisions in *In re Mutual Funds Invest. Litig.*, 384 F. Supp. 2d 845, 860 (D. Md. 2005), *In re Parmalat Secs. Litig.*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005), *In re Charter Communications, Inc.* , 443 F.3d 987 (8th Cir. 2006), and *Armstrong v. McAlpin*, 699 F.2d 79 (2d Cir. 1983), do not apply because the individual respondents are each primary violators who directly participated in the manipulative scheme.

Respondents' reliance (Sheehan Ans. at 17-18) on *Janus Capital Group, Inc. v. First Derivative Traders*[106] is also misplaced. That case decided questions specific to "misrepresentation" violations under SEC Rule 10b-5(b), and not the "scheme" and "fraud" provisions under SEC Rule 10b-5(a) and (c) which mirror the 1c.2 language at issue in this case. Moreover, that case was decided not in the context of government

[106] *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

enforcement actions but, rather, in the context of the "narrow scope" of "the implied private right of action" for which a plaintiff must prove reliance.[107] This case is irrelevant to the facts and legal principles in this investigation as reliance is not an element of the Anti-Manipulation Rule.[108]

## II. False Statements Violation

### A. Respondents Misstate the Facts About the Section 35.41(b) Violations

Unable to effectively rebut the allegation that Coaltrain violated section 35.41(b), Respondents resort to dramatic tones to dispute some of the fact allegations contained in the Staff Report. Their arguments do not withstand scrutiny.

#### 1. Enforcement's Discovery of the Spector 360 Records

Respondents contend (Ans. at 75, Jones Ans. at 4) that Enforcement misstates how they were found to have been hiding the Spector 360 records. That is not correct. Since Respondents put so much emphasis on this issue, it is worth a brief explanation. As the Staff Report states (at 63), "Enforcement only learned about Spector360 on its own, *after* Enforcement had discovered an *oblique reference* to the company's computer monitoring software in a document explaining why one of Coaltrain's traders had been terminated in early June 2010."[109] That document was a mere attachment to the company's submission to the state unemployment commission filed in an attempt to deny a terminated employee's application for benefits. In that attachment, the company explained that it "provides to all employees a home computer system which allows them to perform [their trading] functions. Each employee is aware that we employ security monitoring software that records every activity performed on a company computer."[110] That is all. This document did not address the nature and scope of what Spector 360 does, nor did it name the software used. Nor did it give any indication that this "security monitoring software"

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[107] *Id*. at 2303.

[108] Order No. 670, FERC Stats. & Regs. ¶ 31,202 at P 48.

[109] Staff Report at 63 (emphasis added).

[110] Bates No. COALTRAIN0000812.

generated a cast of materials that had not been searched for responsiveness to Enforcement's data requests. Shortly thereafter, Enforcement discovered from the former employee what the company actually meant by "security monitoring software"—that it was a "key-logger" software system that captured absolutely everything that the employees did on their computer. And it is after that when Enforcement specifically asked Respondents about their computer security monitoring software.

Put simply, the company's comment buried in a response to an unemployment insurance application began the process by which Enforcement uncovered the missing Spector 360 records, but it was the former employee's assistance that completed it. Thus, the Staff Report is correct in stating (at 14) that "[i]n June 2012, Enforcement discovered from a former Coaltrain employee that Respondents had failed to produce an enormous set of documents that were highly relevant to the matters under investigation and responsive to Enforcement's prior data requests."

**2. <u>Enforcement's "Actual Knowledge" of Spector 360 in 2009</u>**

Respondents also contend that their false statements and material omissions about the Spector 360 records are excused because, they say, "[b]y virtue of the *Kourouma* matter, the Commission's Enforcement Staff obviously knew in 2009 that Coaltrain possessed and used the [Spector 360] software." Ans. at 72. That contention is wrong for many reasons.

*First*, Respondents are wrong about the facts. The *Kourouma* docket (ER09-805) contains no mention whatsoever of Coaltrain, nor does the Staff Report say that it does. What happened in *Kourouma* is that a *different* company, called Energy Endeavors LP ("Energy Endeavors"), protested a market-based rate authority application by Quntum Energy LLC ("Quntum"), which was controlled by one of Energy Endeavors' employees, Moussa Kourouma. In that docket, Energy Endeavors (through an affidavit by Shawn Sheehan) told the Commission that it had used a "commercially available software program for monitoring employee use of the Company computer system" to uncover

facts relevant to Quntum's application.[111] Nothing in the *Kourouma* docket says that an entity not mentioned in those filings, Coaltrain, used Spector 360, much less that it did so in 2010.

*Second*, Coaltrain's argument is based on an untenable premise: that when an Enforcement staff member receives a response to data requests from Entity A in Investigation X, the Enforcement staff member is required to search the files of other investigations, involving different entities, and handled by other members of Enforcement staff, to find out whether those files contain information showing that Entity A's data responses in Investigation X are inaccurate.[112] In fact, common sense dictates that a company responding to an investigative request for documents *from its own files* has the basic obligation to review all information in its possession. Here, Coaltrain can certainly be expected to look into something that everyone in the company knows: that the firm uses software to monitor and log everything that its employees do on their computers, all day long, every day, whether in the office or at home. Coaltrain's attempt to shift blame for its own failure to produce its own responsive documents that it knew to be in its possession—or even to have reviewed those documents for responsiveness—simply defies logic and ignores the basic obligations of all entities responding to discovery requests.

*Third*, it would not matter if (contrary to fact) Enforcement staff had immediately realized that Coaltrain had made false statements and material omissions about Spector 306 in its responses to data requests. Section 35.41(b) applies to *all* false and misleading

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[111] Energy Endeavors Mot. for Leave to Intervene and Protest, Docket No. ER09-805-000, Shawn Sheehan Aff. at ¶ 7 (filed Apr. 3, 2009).

[112] Similar arguments have been raised—and rejected—in proceedings before the Commission. *In Enron Power Mktg., Inc., et al*., Docket No. EL03-113, Enron contended that the public disclosure of a contractual relationship which was subsequently reported in the media sufficed to put the Commission on notice of a change in status about which it was required to inform the Commission. That contention was rejected by the ALJ, and that aspect of the ALJ's decision was affirmed by the Commission. *See Enron Power Mktg., Inc., et al*., 104 FERC ¶ 63,010, at PP 69, 98, 105 (2003) (rejecting arguments that public disclosure of a change in status satisfies the duty to report a change in status), *aff'd in relevant part*, 108 FERC ¶ 61,071 (2004).

statements and material omissions by covered entities (absent due diligence), not just to statements and omissions that actually deceive the audience. In the *Kourouma* case, for example, Commission staff was immediately alerted—by Energy Endeavors—of the false statements in the Quntum application, and the Commission never relied on them. The Commission nevertheless imposed penalties on Kourouma under section 35.41(b), in an order later upheld by the D.C. Circuit.[113]

Similarly, in *JP Morgan Energy Ventures Corp.*,[114] an entity with market-based rate authority (JP Morgan Ventures Energy Corporation, or "JPMVEC") made false statements in a Complaint filed on May 21, 2012 (docketed as EL12-70). Before the Commission took any action on the Complaint, on June 20, 2012, Enforcement made a submission in the EL12-70 docket showing that the statements in JPMVEC's Complaint were false. JPMVEC immediately withdrew its Complaint and the Commission never relied in any way on the false statements. Nevertheless, the Commission later determined that JPMVEC had violated section 35.41(b) by making the false statements and suspended the firm's market-based rate authority for six months as a sanction for the violation.

The Commission's imposition of sanctions in *Kourouma* and *JPMVEC* for communications whose falsity was immediately detected is entirely appropriate under section 35.41(b), because reliance is not an element of a violation of that rule. Indeed, it would not matter even if it were factually impossible for Commission staff to have relied on Coaltrain's false statements and material omissions about Spector 360.[115]

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[113] *Kourouma v. FERC*, 723 F.3d 274, 278 (D.C. Cir. 2013).

[114] *JP Morgan Energy Ventures Energy Corp.*, 141 FERC ¶ 61,131 (2012).

[115] *See United States v. Dixon*, 449 F.3d 194, 202 n.9 (1st Cir. 2006) ("Since the elements of those offenses do not require that the unlawful goal be achieved, factual impossibility is irrelevant.") (citations omitted).

### 3. Respondents Were Not Candid With The IMM

#### a. Coaltrain Was Aware That SouthImp-Exp Was Not a Profitable Trade

Respondents claim (Ans. at 53-55) that they did not have notice that SouthImp-Exp was a problematic trade. They cite for this proposition evidence that the public was not expressly on notice that SouthImp and SouthExp were tied together, and that they themselves did not actually learn about this until their call with the IMM on July 26, 2010. Ans. at 54. But the Staff Report did not allege that the Respondents actually knew that SouthImp and SouthExp were tied together (and thus that a price spread could appear only as a result of error); instead, the Staff Report alleges that from their intensive research Respondents knew that the Day-Ahead spread was zero on the path (itself notice that something was odd about the path) and that it was nearly impossible to make any profits on the Real-Time spread.[116] Despite knowing this, the Respondents elected to make frequent, large-volume trades on the path, losing money on charges day after day, and they made it even less likely that they would make a profit by unnecessarily paying to reserve transmission to be eligible for MLSA payments. The manipulative character of Respondents' SouthImp-Exp trades did not depend on them having actual notice that the pricing points were tied together; it was based on the fact that they knew that the path was uneconomic and made trades on the path in a manner that was inconsistent with an intent to profit from price spreads.

#### b. Coaltrain Made False and Misleading Statements to the IMM

##### i. Calls with the IMM

Respondents contend (Ans. at 55-61, Jones Ans. at 9-10, 18-20) that they did not make false statements to the IMM in their phone conversations in late July and early August 2010.[117] In the first call, dated July 26, 2010, Respondents emphasize that the

[116] *See* Staff Report at 75.

[117] Since the IMM did not consent to having the conversation recorded, Respondents' recordings were made under circumstances of questionable legality. *See generally, Barasch v. Pennsylvania Pub. Util. Comm'n*, 133 Pa. Cmwlth. 285, 295, 576 A.2d 79, 84 (1990), *aff'd sub*

IMM did not say that they had violated market rules, and contend that this is exculpatory and that it indicates they did not have prior notice.[118] Ans. at 55, Jones Ans. at 10. But that reads far too much into the call, and that ignores that this was a short call made at the beginning of the IMM's investigation of the matter, before the IMM had had a chance to gather and review evidence and to make an independent decision. As the IMM said, they were not ready to accuse the Respondents of misbehavior and that the investigation was "just … factual at this point."[119] (Of course, the IMM was unaware of the inculpatory evidence contained in the firm's Spector 360 data.)

In the second call (also July 26, 2010), another IMM employee questioned Jones about SouthImp-Exp and NCMPAImp-Exp, and while he was not aware at that time of any "business rule" prohibiting the trade, he informed them that SouthImp and SouthExp were tied together.[120] Thus, Jones was made aware not only that SouthImp-Exp was inappropriate, but he also had notice that NCMPAImp-Exp was likely also inappropriate—but far from stopping the NCMPA trades, Coaltrain actually tripled its volume on that path to substitute or replace the OCL volume lost when Coaltrain stopped trading SouthImp-Exp. (This shift mirrors what City Power did after Mr. Jurco objected to the firm's SouthImp-Exp trades.)

In the third call (July 27, 2010), after having had time to look at more evidence, the IMM informed Jones that making trades such as SouthImp-Exp to "arbitrage the … marginal losses" was "not really a legitimate reason [] to engage in the transaction."[121]

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*nom. Barasch v. Bell Tel. Co. of Pennsylvania*, 529 Pa. 523, 605 A.2d 1198 (1992) (describing Pennsylvania's two-party consent rule); *Simmers v. Packer*, 1997 WL 1050723, at *3 (Pa. Com. Pl. 1997) ("The law in Pennsylvania provides that if all parties to a communication have not consented to the interception, there is a violation of the Wiretapping Act." (*citing Commonwealth v. Jung*, 366 Pa. Super. 438, 448, 531 A.2d 498, 503-504 (1987)); *Hemphill v. City of Wilmington*, 813 F. Supp. 2d 581 (D. Del. 2011) (a secret recording apparently violated Delaware's privacy laws).

[118] OE Trans. of COALTRAIN000326.

[119] OE Trans. of COALTRAIN000326 at 1.

[120] OE Trans. of COALTRAIN000328.

[121] OE Trans. of COALTRAIN000330.

The IMM further explained that it was legitimate to profit from price spreads, but not "making money entirely from the [] payback of the marginal losses," and warned that doing so was inconsistent with "the spirit of the rules." So while the IMM only pointed directly to the SouthImp-Exp trades as the "primary" trade he was concerned about, his explanation that it was not legitimate to trade to collect MLSA covered all of Coaltrain's OCL trades.

In the fourth call (July 30, 2010), for which no recording exists, the IMM directly told Jones to stop trading on NCMPAImp-Exp, and Jones complied.

And in the fifth call (Aug. 6, 2010), after the IMM had an opportunity to review the facts more closely, the IMM made it clear that they had not yet "identified the entire universe" of illegitimate trades, and clarified that "we're happy to identify the universe more broadly" to include "uneconomic transactions."[122]

#### ii. Respondents Did Not Stop Making OCL Strategy Trades After the Calls With the IMM

Respondents contend (Ans. at 58-60) that they did not mislead the IMM because they stopped making SouthImp-Exp and NCMPAImp-Exp trades after being expressly asked to do so. It is correct that they stopped making trades on the paths that the IMM explicitly identified as being inappropriate. But the IMM's concerns did not end there. The IMM explained that UTC trades were intended to profit from price spreads, not "making money entirely from the [] payback of the marginal losses," and warned that doing so was inconsistent with "the spirit of the rules."[123] As discussed above, in the fifth recorded call (of August 6, 2010), the IMM made it clear that the "entire universe" of illegitimate trades had not been uncovered as yet.[124]

In this context, Peter Jones's statements that Coaltrain would abide by the IMM's concerns were misleading, because as he knew the paths specifically identified by the IMM—SouthImp-Exp and NCMPAImp-Exp—were the best, but not the only, OCL

[122] OE Trans. of COALTRAIN011541.

[123] OE Trans. of COALTRAIN000330.

[124] OE Trans. of COALTRAIN011541.

trades, and he knew that the OCL Strategy was intended to make money from "payback of the marginal losses." Nevertheless, Respondents continued making hundreds of thousands of MWh of OCL Strategy trades throughout August and into September; in fact, they continued making the trades *after* PJM had filed a request to amend the tariff—after, that is, PJM publicly told everyone that trading to collect MLSA was inappropriate and wrong. For instance, on August 5, 2010, both the Market Monitor and PJM made presentations to PJM's Markets and Reliability Committee ("MRC") about the sham UTC trading schemes, and each condemned it.[125] The next day, the Market Monitor and PJM participated in a conference call in which they stated that those who engaged in the scheme "receive[d] an 'unfair' financial benefit with no economic risk" and tied up transmission "with transactions of no real 'value.'"[126] Almost a week later, on August 12, 2010, the IMM made a presentation to the PJM Members' Committee in which he called the sham UTC trading scheme "market manipulation."[127] But Coaltrain did not stop making OCL trades until early September, just two weeks before the tariff was changed. Accordingly, Coaltrain's assurances to the IMM were false and misleading because Coaltrain kept making OCL trades long after it was aware that the strategy was inappropriate, and long after assuring the IMM that it would not make such trades.

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[125] *See* Stu Bresler, *Marginal Loss Proposal: Continued Discussion*, Markets and Reliability Committee (Aug. 5, 2010), *available at* http://www.pjm.com/~/media/committees-groups/committees/mrc/20100805/20100805-item-08-marginal-losses.ashx

[126] 2-PJMDOCS-#606249-v1-REDACTED_Conference_Call_Redacted.pdf (Aug. 6, 2010) (Document produced by PJM on Jan. 11, 2011).

[127] J. Bowring, *Impacts of Proposed Solutions to Manipulation Arising from Allocation of Marginal Loss Surplus*, at 2 (Aug. 12, 2010), *available at* http://www.monitoringanalytics.com/reports/Presentations/2010/IMM_MC_Loss_Surplus_Allocation_20100812.pdf. Monitoring Analytics also filed comments in the ER10-2280 proceeding to amend PJM's tariff, and in those comments the Market Monitor repeatedly referred to the sham UTC trading scheme as "gaming" and "market manipulation." Mot. to Intervene and Comments, Docket No. ER10-2280-000, at 3-4, 15 (filed Sept. 2, 2010).

#### iii. Coaltrain's Statement About Seeing Price Differences Was Misleading

Next, Respondents contend (Ans. at 60-61) that it was not misleading to tell the IMM that they made the SouthImp-Exp trades after "we saw price deltas in the day ahead and in the real time." Ans. at 60 (quoting Bates No. COALTRAIN011541 at ca. 6:27-6:57). While it is true that they had in fact seen *some* price spreads because they had analyzed the path, that statement was misleading because it gave the impression (and was plainly intended to give the impression) that they had first made the trades to capture those "price deltas" when in fact the trades were aimed at MLSA.[128]

### 4. Respondents' *Post Hoc* Rationalizations

Respondents also contend (Ans. at 86-88) that they were not attempting to create a *post hoc* rationalization for their SouthImp-Exp trades when, in the wake of the IMM's call and then Enforcement's investigation, they began gathering evidence showing price differences between SouthImp and SouthExp. They first state that they had already collected the evidence by that time, and so the request made to Hughes on August 19, 2010 to calculate the number of five-minute pricing intervals on that path "was simply gathering evidence to demonstrate what it already knew: there was a history of publicly-reported price divergence at these two nodes." Ans. at 87. But the evidence shows that, after receiving the First Data Request on August 19, 2010, the Respondents immediately assessed their SouthImp-Exp data to create an after-the-fact rationale that they later used to make it appear as if the five-minute data analysis they performed on August 19 had played a material role in the decision they had made two months earlier to trade SouthImp-Exp. For instance, in his first deposition, Peter Jones testified that they "executed" the SouthImp-Exp transaction because they saw "a potential for the next-day market was one that had price divergence on a number of constraints," and when asked about the significance of this price divergence, Jones replied "well, when we do our analysis, we look at all the data that we have for the south imp/south exp, and all the data that we have shows that there was price divergence in those two interfaces. Other data

[128] *See, e.g.,* Staff Report at 49.

that we have is 37.2 percent of the time. It's like 118,000 times those prices diverged."[129] The "118,000" figure in Jones's testimony was derived from their *post hoc* August 19 analysis of five-minute LMP differences.

Respondents also dispute (Ans. at 87-88) the Staff Report's characterization of the Spector 360 screenshots showing that, on August 5, 2010, Hughes calculated "apparently for the first time" that there had been a small price divergence on the SouthImp-Exp path about 38% of the time. Respondents state (Ans. at 88) that this characterization is contradicted by a Spector screenshot on June 17 depicting Hughes sorting the SouthImp-Exp path by price divergence. But this confuses the two screenshots. On June 17, Hughes sorted SouthImp-Exp by the size of the price divergence for the period January 1, 2010 through June 17, 2010. This plainly demonstrated that the prices had diverged in the past to some small (and rare) extent—only about 15 of roughly 4,000 hours in that period had a positive price difference exceeding the 32 cents of charges that Hughes had estimated—but the screenshots *do not show* Hughes calculating *how frequently* the differences had occurred. That is precisely what Hughes did on August 5: he analyzed the data and calculated that prices had diverged (by even as little as a penny) approximately 38% of the time. That is the new information that Respondents learned at that time, and that is the figure that Peter Jones quoted during his testimony, making it appear as if the 38% figure was part of their *ex ante* decision to trade SouthImp-Exp.

Respondents state (Sheehan Ans. at 13) that Sheehan's inquiry to Hughes on September 16, 2010 about whether they could use their software to identify trades if they were spreads was a reference to "virtual spreads" (*i.e.* a spread between an inc and a dec), not UTCs. But the context of the IM conversation between Hughes and Sheehan shows that Respondents are wrong. The conversation started with Hughes sending (via IM) the path to a file called "Deal Profitability per month" in a folder called "pjm\OCL Info," and then Hughes explained that "we make money on 40% of our trades." Sheehan thought that was "nice" because "its strong evidence of loss leaders," and Hughes responded that

[129] P. Jones Test. Vol. I Tr. 80:19-81:17.

"July was our second best month even excluding southimp-southexp." About ten minutes later, Sheehan asked "for the profitability is there a way to link the trades if they were spreads" and said that "I would imaging [sic] the percentage woudl [sic] be higher if we did that."[130] This is plainly a discussion about the document that Hughes had forwarded. And that document (shown below) was about UTCs—it described how many "Total Deals" "Made Money" and expressly excluded SouthImp-Exp (which is a UTC trade—not a "virtual spread" of incs and decs):[131]

| | A | B | C | D | E |
|---|---|---|---|---|---|
| 1 | Month | Total Deals | Made Money | Percent | |
| 2 | 1/1/2010 | 538 | 221 | 41.1% | |
| 3 | 2/1/2010 | 439 | 165 | 37.6% | |
| 4 | 3/1/2010 | 845 | 396 | 46.9% | |
| 5 | 4/1/2010 | 1035 | 373 | 36.0% | |
| 6 | 5/1/2010 | 847 | 315 | 37.2% | |
| 7 | 6/1/2010 | 1075 | 399 | 37.1% | |
| 8 | 7/1/2010 | 958 | 425 | 44.4% | |
| 9 | 8/1/2010 | 827 | 364 | 44.0% | |
| 10 | **Total** | **6564** | **2658** | **40.5%** | |
| 11 | | | | | |
| 12 | Excludes SOUTHIMP - SOUTHEXP | | | | |

In short, Respondents are wrong: on September 16, 2010, Sheehan was asking about UTCs, not "virtual spreads."

### 5. Respondents Do Not Rebut The Staff Report's Allegation That They Made False Statements In The First And Fifth Data Requests

Respondents do not attempt to contradict the allegations in the Staff Report that among their false and misleading statements and material omissions were their responses to the First and Fifth Data Requests. As the Staff Report detailed (at 66-67), in the First Data Request (August 2010), Coaltrain was asked to identify every employee who submitted UTC trades during the summer. In response, Coaltrain identified most of the traders, but did not identify three other employees who had submitted UTC trades.

[130] Bates No. COALTRAIN007990.

[131] Excerpt from Bates No. COALTRAIN009459.

Furthermore, in the Fifth Data Request (Staff Report at 106-107), Coaltrain stated that it was not able to "retrieve" the Spector 360 data because "neither Coaltrain Energy nor Crane has a license to access" it. However, that statement was false. As a later-discovered email from Gary Wrinn to Peter Jones revealed (Staff Report at 107), Wrinn was able to export the Spector data in early July 2012—several weeks *before* Coaltrain responded to the Fifth Data Request—and Peter Jones knew it. This means that Coaltrain's subsequent statement to Enforcement that it could not access the Spector 360 data was false and misleading. This evidence makes it clear that the company gave false and misleading statements in the Fifth Data Request.

### 6. False Statements Were Made About One Witness's Ability to Testify

Respondents state that the Staff Report inaccurately claims that two of the named individuals made false and misleading statements about a witness's ability to testify. Jones Ans. at 5-9. This is not correct. As the Staff Report notes (at 67 & n. 252), the issue is the false or misleading representation that *prior counsel* made on behalf of Coaltrain in an email to Enforcement concerning the witness's health and inability to testify. Based on the representations in that email, Enforcement agreed to postpone the witness's testimony. In fact, Enforcement later offered to withdraw the subpoena entirely if prior counsel would submit a declaration from a medical professional attesting to the witness's health and inability to testify. Prior counsel did not do so, and instead told Enforcement that the witness would testify. During the testimony that followed, prior counsel at first denied having made the representation to Enforcement regarding the witness's health and inability to testify that were contained in the email counsel had sent to Enforcement. When the email was introduced as an exhibit[132] and shown to the witness, *that same witness testified that he was not aware of prior counsel's representation and that the representation was not correct*.[133] Coaltrain's misrepresentation delayed the witness's testimony by about six months, and but for

[132] Wells Test. Tr. 218:18-23; *id.* Ex. Set 2 Ex. 1.

[133] *See* Staff Report at 67 n.252; Wells Test. Tr. 218:25-219:17.

Enforcement's request for a declaration from a medical professional before agreeing to withdraw the subpoena, may have altogether prevented Enforcement from taking testimony from one of the most important witnesses in this matter.

### 7. Sheehan Makes New False Statements About His Awareness of Spector 360 In His Declaration

Finally, Sheehan made *new* false statements in the materials submitted to the Commission in this proceeding. Despite swearing "under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information and belief at the time of its execution," Sheehan states in the declaration he submitted as an attachment to the Answer filed on March 4, 2016 (Sheehan Decl. ¶ 14) that:

> I do not recall ever having used Spector 360 software myself. I do not use nor have I ever purchased or authorized the purchase of Spector 360 for use at my current companies, XO Energy, LLC and its affiliates. In that context, contrary to Staff's assertion, I did not understand information recorded by Spector 360 to be "plainly responsive" to any data request prior to Enforcement Staff's July 3, 2012 Fifth Data Request to Coaltrain Energy, L.P.

The meaning and intent of this statement is self-evident: Sheehan was so unfamiliar with Spector 360 that he could not have been aware that it could have recorded responsive materials. But that is misleading for several reasons.

In the first place, Sheehan was plainly aware of Spector 360 and its functionality while he owned and operated Coaltrain. First, he submitted two affidavits to the Commission in 2009 attached to submissions that his then-firm (Energy Endeavors) made regarding former employee Kourouma based on the information he and others gleaned from Spector 360; in fact, in Energy Endeavors' supplemental protest in that proceeding, not only did Sheehan reiterate in his declaration that the company had used "a commercially available software program for monitoring employee use of the Company computer system," but attached as Appendix C were two screenshots.[134] Not only that, but Crane Energy (owned and operated by Sheehan and Jones) sued Kourouma in

[134] Energy Endeavors Supplemental Protest, Docket No. ER09-805, at App. C (filed May 8, 2009).

Delaware Chancery Court, and in their complaint they included specific allegations of Kourouma's wrongdoing and explained that "Energy [Endeavors] was able to discover Kourouma's aforementioned actions because he performed them on a computer (or cell phone) provided to him by Energy [Endeavors]."[135] Second, as described in the Staff Report, in May-June 2010, Sheehan and Jones again used the same software to terminate another trader. Third, again as the Staff Report relates, Sheehan was a party to internal discussions concerning Spector 360 just days before receiving the Second Data Request.[136] It is inherently incredible to assert that Sheehan did not know what Spector 360 did (and, by definition, what it recorded and preserved) in 2010-11.

Moreover, his declaration is misleading as it concerns XO Energy. After Sheehan left Coaltrain to form XO Energy, LLC and its many affiliates, he purchased and used a leading competitor to Spector 360 called "Work Examiner" to monitor his employees, and he even used that software to gather evidence for a legal action he pursued against a former employee. In 2015, XO Energy filed a lawsuit against a former employee in Texas. In the complaint, the company declared:[137]

> 17. As part of its data security efforts, Plaintiffs use Work Examiner, an internet monitoring software. One of Work Examiner's key functions is to capture screenshots of the computers accessing its systems in various increments. XOE can later recall and review those screenshots.

The company proceeded to attach a number of screenshots that, it claimed, provided key evidence of the former employee's conduct.[138] Sheehan thus seeks to have it both ways. On the one hand, he defends his failure to review and produce the Spector 360 documents

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[135] Complaint at ¶ 28, *Crane Energy, Inc. v. Kourouma*, No. 4512-VCS (Del. Ch. April 15, 2009); *see also, id.* ¶¶ 26-31 (describing their allegations against Kourouma and the means by which they uncovered his acts).

[136] Staff Report at 64-65, 109-111.

[137] Second Amended Complaint at ¶ 17, ECF No. 18, *XO Energy LLC et al. v. Zhao*, No. 4:15-CV-00599 (S.D. Tex. April 5, 2015). The original and first amended complaints included the same paragraph.

[138] *See, e.g.*, Exhibits C-1, C-2, C-3, C-4, and D, attached to the Second Amended Complaint.

by swearing that the fact that he did not purchase or use Spector 360 himself or authorize its purchase at XO Energy provides the "context" that excuses why he "did not understand information recorded by Spector 360 to be 'plainly responsive.'" On the other, Sheehan purchased and used at XO Energy one of Spector 360's leading competitors *to perform precisely the same function*, and in fact recognized that the screenshots preserved by the software *constituted relevant evidence*.

Put simply, Sheehan's statement is misleading—and plainly intended to mislead—because between 2009 and 2015 he purchased and repeatedly used evidence from Spector 360 *and* a leading competitor to watch, investigate, and terminate his employees at, successively, Energy Endeavors, Coaltrain, and XO Energy. On at least three occasions, he terminated employees because of evidence recorded by his computer monitoring software, and he initiated litigation against at least two of his employees (and filed an administrative protest with the Commission against one) using the recorded screenshots as his evidence. Even if Sheehan did not *personally* install or use Spector 360 and Work Examiner, he plainly was aware of the software and directed his subordinates to use it to monitor and investigate his traders. The fact that he is now denying awareness of the software or what it records is misleading.[139]

### B. Respondents' Legal Arguments About Section 35.41(b) Are Incorrect

Coaltrain contends that, as a matter of law, the Commission lacks authority to impose penalties against it for violations of section 35.41(b) based on its conduct relating to the Spector 360 data and other false and misleading statements. And Peter Jones, Robert Jones, and Jack Wells advance a related argument in defense of the company's communications about Spector 360. None of these contentions is correct.

[139] XO Energy and its affiliates have market-based rate authority, and Sheehan's misleading statement appears to transgress XO Energy's duty of candor. *See* Docket Nos. ER11-3214-000, ER11-3215-000, and ER11-3212-000.

### 1. **This Case is About False Statements and Material Omissions, Not a "Discovery Dispute"**

At the outset, Coaltrain's characterization of the conduct at issue here—as a "routine discovery dispute" (Ans. at 76)—is incorrect. Coaltrain's false statements and material omissions concerning the Spector 360 data were not part of a "discovery dispute," much less a "routine" one. "Discovery disputes" arise when a party openly raises good faith objections that requested materials are not properly subject to discovery (*e.g.*, because they are privileged, have no connection to the issues under investigation, or would be unduly burdensome to produce). But that is not what happened with the Spector 360 data. Enforcement did not become aware of the omitted Spector 360 records until July 2012—nearly two years after this investigation began—and Coaltrain's tardy production of the missing records considerably delayed this matter.

Coaltrain *did* openly raise certain objections to some of staff's data requests.[140] But it did *not* object to producing the Spector 360 data. Instead, in each of its communications about staff's Second Data Request, including submissions on November 12, December 8, and December 22, 2010, and on February 2 and February 22, 2011, Coaltrain omitted the material fact that it possessed, but was not producing, enormous volumes of Spector 360 data that were responsive to one or more of the items in the Second Data Request.[141] In doing so, Coaltrain violated section 35.41(b).

As demonstrated in the Staff Report, these material omissions were part of a deliberate cover-up. But they would violate section 35.41(b) even if they had not been intentional: that provision protects against liability misleading statements and material omissions only if they occurred "despite the filer's due diligence."[142] Here, as discussed below, even the most minimal due diligence would have revealed that Coaltrain

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[140] *See* Letter from Coaltrain Counsel to Enforcement Staff (Nov. 12, 2010); Letter from Coaltrain Counsel to Enforcement Staff (Dec. 22, 2010).

[141] The Spector 360 data included material responsive to at least eight questions in the Second Data Request (as amended): Nos. 2, 4, 5, 8, 9, 12, 18, 19, and 23. *See* OE Second Set of Data Requests to Coaltrain (Nov. 5, 2010).

[142] *Kourouma v. FERC*, 723 F.3d at 278 (D.C. Cir. 2013).

possessed the Spector 360 data. Coaltrain's omission of the material fact that it possessed responsive Spector 360 data therefore violated section 35.41(b), regardless of whether the omission was intentional.

Coaltrain also violated section 35.41(b) by making false and misleading statements about the completeness of its responses to the Second Data Request. On February 2, 2011, for example, Coaltrain submitted responses to Questions 1 and 23 from the Amended Second Data Request. Although the Spector 360 data were responsive to Question 23, and although it was producing no Spector 360 data, Coaltrain falsely assured staff in its February 2, 2011 response to Question 23 that "*the only documentation and data Coaltrain has regarding its loss credit allocation is in the form of settlement reports provided by PJM*."[143] In fact, as the screenshots in the Staff Report demonstrate, Coaltrain's trove of Spector 360 data contained voluminous "documentation and data" about Coaltrain's loss credit allocation.

In addition, on February 2, 2011, Coaltrain certified (through a declaration of Peter Jones) that Coaltrain's submission "constitute[d] a true, *complete* and accurate

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[143] Data Request No. 23, and Coaltrain's February 2, 2011 response, are reprinted here:

> "23. Provide all documents and data showing transmission loss credit allocations to Coaltrain for the period January I, 2008 through October 31, 2010. Also provide all documents and communications relating to any transmission loss credit allocations to Coaltrain during that period and documents and communications showing analyses, evaluations, calculations or derivations of any transmission loss credit allocations to Coaltrain during that period.
>
> Response:
>
> *The only documentation and data Coaltrain has regarding its loss credit allocation is in the form of settlement reports provided by PJM*. Coaltrain makes this data and all other settlement data available in its proprietary software so that an analyst may evaluate a proposed transaction to determine if it has the potential to be profitable given settlement charges and credits.
>
> Attached to this submittal are the PJM Settlement Reports, which provide the loss values."

Coaltrain Response to Question 23, attached to Letter from Coaltrain Counsel to Enforcement Staff (Feb. 2, 2011) (emphasis added).

response to the requests, to the best of [Jones'] knowledge, information and belief." [144] Since Peter Jones was personally well-acquainted with Coaltrain's use of Spector 360—having used it to terminate two different employees, one only a few months earlier[145]—his certification was false and misleading as to his own "knowledge, information, and belief." In any event, as discussed below, Coaltrain would still have violated section 35.41(b) even if Jones had made the statement in good faith, because of the firm's lack of due diligence.

Similarly, Coaltrain's responses to the First and Fifth Data Requests were also false and misleading in violation of section 35.41(b), as discussed above.

### 2. Coaltrain Did Not Exercise Due Diligence

Coaltrain claims that its "statements to Staff were truthful when made, and [that it] exercised appropriate due diligence before making them." Ans. at 67 (footnote omitted). Neither assertion is true.

As discussed above, Coaltrain's statements that its production was complete was indisputably false when made. As to Peter Jones's February 2, 2011 certification, even if Jones had made that certification about his own knowledge in good faith, Coaltrain itself would still be liable under section 35.41(b). As the Commission explained in adopting the rule:

> In this regard, we intend the "due diligence" exception to apply to the entity, not the individual, submitting the data. As such, we expect the seller submitting the information to have in place processes that assure the accuracy of the submitted information. *The submission of false or incomplete information on behalf of a seller by an individual that did not personally know it to be false or incomplete in the absence of a process to insure data accuracy and sufficiency will not excuse the seller's conduct under this rule.*[146]

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[144] Letter from Coaltrain Counsel to Enforcement Staff with Attached Affidavit of Peter Jones (Feb. 3, 2011) (emphasis added).

[145] Staff Report at 104-5.

[146] *Investigation of Terms & Conditions of Pub. Util. Mkt.-Based Rate Authorizations*, 105 FERC ¶ 61,218, at P 110 (2003) ("2003 Order Amending Market-Based Rate Tariffs and Authorizations ") (emphasis added).

Coaltrain plainly did not "have in place processes [to] ensure the accuracy of the submitted information," since Coaltrain's use of Spector 360 was common knowledge throughout the company.[147]

Coaltrain argues (Ans. at 69-70) that "[t]he retention of experienced counsel, in and of itself, is evidence of due diligence and tends to negate any inference that Coaltrain intended to withhold relevant evidence or mislead the Staff."[148] But the Commission has squarely rejected that argument: in revoking an entity's market-based rate authority, the Commission found that "retainer of qualified attorneys does not constitute sufficient due

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[147] That due diligence would have revealed that Coaltrain possessed the Spector 360 data is shown by the following facts, among others:

(a) Peter Jones and Shawn Sheehan had used the Spector 360 data the previous year (2009) to "download[] pictures from [an employee's] phone at Peter Jones's request [and] track[] [the employee's] bank transactions and his online real estate searches . . . ." (Staff Report at 63-64)

(b) "In late May 2010 . . . Jones and Sheehan used Spector 360 to review another trader's activities . . . Peter Jones updated his access credentials [for SpectorSoft] and then reviewed the data and terminated [the second employee] in early June." (Staff Report at 64)

(c) Coaltrain paid annual license fees for Spector 360. (*Id.*)

(d) Coaltrain's IT department was in touch with the vendor for Spector 360 14 times between August 2010 and January 2011. (*Id.*)

(e) Coaltrain's employees and owners "discussed Spector 360 in the weeks and months leading up to (and following) their false responses to Enforcement's data requests. (*Id.*)

[148] Respondents also appear to be making an advice-of-counsel defense. In particular, they state in their Answer that "Coaltrain retained prior counsel to assist in the collection and production of the responsive information. It was *reasonable for Coaltrain to rely on prior counsel's experience and expertise* to ensure that the responses to the Staff data requests were appropriate and complete." Ans. at 69 (emphasis added). This is similar to language included in their response to the 1b.19 letter in which they stated that "Coaltrain—like any other company—relied on counsel to comply with Staff's discovery requests." Coaltrain Resp. to 1b.19 letter at 16 (Oct. 19, 2015). After Enforcement questioned them about this statement in their 1b.19 response, Respondents subsequently sent a letter to Enforcement that read "[w]e are not—at this time—asserting an advice-of-counsel defense." Coaltrain Counsel Letter to Enforcement at 1 (Oct. 30, 2015). Having made that assurance, they cannot backpedal now, when Enforcement relied on their representation in not pursuing discovery about prior counsel's advice (as to which Respondents would waive any privilege by asserting an advice-of-counsel defense). In any event, the advice-of-counsel defense has no application here because counsel's advice is not a defense to the company's failure to exercise due diligence in establishing proper procedures for responding to investigative requests.

diligence to exonerate JP Morgan's violations [of § 35.41(b)]."[149] That conclusion is equally applicable here, since Coaltrain obviously knew much more about its own documents than an outside attorney, who would need to depend on the company to tell him or her what documents the company possessed.

### 3. Section 35.41(b) Covers All False Statements and Material Omissions to the Commission

Coaltrain contends that section 35.41(b) does not apply to "discovery communications with Enforcement Staff." Ans. at 76. Coaltrain is wrong.

#### a. The Plain Language of Section 35.41 Refutes Coaltrain's Position

Section 35.41(b) prohibits false and misleading statements and material omissions in "*any communication* with the Commission" or other relevant entities. 18 C.F.R. § 35.41(b) (2015) (emphasis added). Nothing in this plain language excludes communications by respondents (or other entities) in investigations by Commission staff, as the Commission held in *JPMVEC*.[150]

#### b. The Commission Has Repeatedly Applied Section 35.41(b) to Communications in Investigations and in Other Non-Rate-Related Contexts

In at least four cases (including one affirmed by the D.C. Circuit), the Commission has made clear that section 35.41(b) covers all false and misleading communications and material omissions with the Commission or other relevant entities.

In the first of these cases, *In Re Edison Mission*, 123 FERC ¶ 61,170 (2008), the Commission approved a Stipulation and Consent Agreement in which Edison Mission agreed to pay a $7 million penalty for violations of section 35.41(b).[151] In the second

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[149] *JP Morgan Ventures Energy Corp.*, 141 FERC ¶ 61,131 at P 42 (*JPMVEC*).

[150] *Id.*

[151] As the Commission explained it its Order approving the settlement, "Edison Mission's conduct [during the investigation] repeatedly resulted in incomplete statements or information that misled staff and impeded staff's analysis." 123 FERC ¶ 61,170 at P 5. Among other things, "Edison Mission's statements to staff regarding the [strategy under investigation] omitted key facts regarding how the strategy was being employed and for which units, and also included information that was inaccurate." *Id.*

case, the Commission imposed sanctions on an individual and his firm for false and misleading statements not in connection with any market transaction but in an *application* for market-based rate authority. *Kourouma v. FERC*, 723 F.3d 274 (D.C. Cir. 2013). The Court of Appeals summarized the effect of section 35.41(b) simply, and without any of the limitations that Coaltrain seeks to impose: "energy traders . . . may not make false or misleading submissions to the Commission or to the other types of entities named in the regulation." *Id.* at 276.

In the third case, the Commission held that by making false statements and material omissions "in the course of responding to the Commission's Office of Enforcement Staff's . . . investigation into its . . . trading conduct, [respondent City Power] violated section 35.41(b) of the Commission's regulations." *City Power*, 152 FERC ¶ 61,012, at P 1 (2015). Far from holding that City Power's conduct was immunized because it occurred in the context of an investigation, the Commission stressed that "the duty of accuracy and candor imposed by section 35.41(b) on regulated Sellers is *particularly important when it involves an investigation by Commission staff into potential violations*."[152]

And in the fourth case, the Commission reached a similar conclusion in *JPMVEC*, in which the entity was found to have violated section 35.41(b) and its market-based rate authority was suspended for false and misleading statements made to the Commission in a complaint about a penalty assessed by an ISO.[153]

The Commission's interpretation of its own rule is, under settled law, entitled to great deference. *Auer v. Robbins*, 519 U.S. 452, 461 (1997) (agency's interpretation of its own regulations is "controlling unless 'plainly erroneous or inconsistent with the regulation.'") (citations omitted).

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[152] *City Power*, 152 FERC ¶ 61,012, at P 216 (emphasis added); *see also id.* P 218 ("The Commission has put market participants on notice of their obligation to be candid, and that it takes false or misleading statements seriously, *particularly when they occur in the context of a staff investigation into potentially improper conduct*) (emphasis added).

[153] *JPMVEC*, 141 FERC ¶ 61,131 at PP 35-47.

### c. Coaltrain's Contention That the Commission Lacks Authority to Penalize False and Misleading Communications in Investigations is Without Merit

Coaltrain advances several arguments that the Commission is powerless to impose civil penalties for false and misleading statements and material omissions by respondents in investigations. None has merit.

First, Coaltrain argues (Ans. at 76) that because the Commission adopted the Market Behavior Rules (codified at 18 C.F.R. § 35.41) based on its authority under FPA section 206 to ensure that rates are just and reasonable, it lacks the power to regulate communications with Commission staff during investigations. But investigations, and impositions of penalties, are part of the Commission's toolbox for ensuring that wholesale power prices are just and reasonable. And section 316A of the Federal Power Act both makes it unlawful to violate "any rule . . . issued under" Part II of the FPA, including 18 C.F.R. § 35.41(b), and also gives the Commission express authority to impose civil penalties on any person who commits such a violation, 16 U.S.C. § 825*o*-1(a), (b). The suggestion that the Commission lacks power under the FPA to penalize violations of section 35.41(b) is therefore without merit.

Second, Coaltrain argues (Ans. at 76-77) that although the language of section 35.41(b) covers *all* communications with the agency, including communications in investigations, the Commission's commentary when it first adopted the rule in 2003 shows that the Commission actually intended the rule to be much narrower. But what the Commission's 2003 Order shows is that the Commission intended what is now section 35.41(b) "to cover *any and all matters* relevant to wholesale markets."[154] Investigations of potential market misconduct are clearly "relevant to wholesale markets," and the Commission's subsequent Orders applying section 35.41(b) to communications in investigations (*Edison Mission*, *Kourouma*, *City Power*, *JPMVEC*) are entirely consistent with the Commission's 2003 Order.

[154] 2003 Order Amending Market-Based Rate Tariffs and Authorizations, 105 FERC ¶ 61,218 at P 103 (emphasis added).

Citing cases about specific statutory provisions (sometimes) trumping general provisions, Coaltrain next argues (Ans. at 77-78) that because FPA Section 307(c) authorizes the Commission to enforce subpoenas in federal court when an entity refuses to comply, the only remedy available to the Commission here is subpoena enforcement. But that makes no sense: subpoena enforcement is a solution to a completely different problem, when a party admits having materials but refuses to produce them. Here, the problem is that Coaltrain did *not* acknowledge that it had the Spector 360 data, and instead made false and misleading statements and material omissions in its communications about them. Section 35.41(b) is an essential tool for (among other things) protecting the integrity of the Commission's investigations, separate and independent from the agency's statutory authority to enforce subpoenas against recalcitrant subjects. *See* discussion of *Edison Mission*, *Kourouma*, *JPMVEC*, and *City Power supra*.

Next, Coaltrain contends (Ans. at 78) that requiring entities to be accurate and candid in their communications with Enforcement will prevent counsel for respondents from raising "good faith" objections to data requests. But as discussed above, Coaltrain did not *object* to producing the Spector 360 data in its 2010-11 responses to data requests. Rather, it failed to disclose that any such data existed, falsely assured Enforcement that its responses were complete, and omitted the material fact that it possessed the Spector 360 data.

Finally, Coaltrain contends (Ans. at 79-81) that because Congress gave the Commission express authority to penalize false and misleading statements that are part of fraudulent market schemes under FPA section 222, which requires proof of scienter, the Commission cannot rely on its broad authority under section 316A to punish *any* false statement or material omission absent proof of scienter. Again, Coaltrain is wrong. The Commission's anti-manipulation authority under section 222 (and 18 C.F.R. § 1c) serves a different purpose than section 35.41(b). The former addresses manipulative *marketplace* conduct, while the latter is designed to ensure candor in communications by entities with market-based rate authority with the Commission and Commission-

regulated entities. As the Commission explained in 2006, section 35.41(b) "applies to *all communications, not just those that are material in furtherance of a fraudulent or deceptive scheme*."[155]

In any event, Coaltrain's argument fails by its own admission. Coaltrain itself says that the "specific trumps general" principle (itself subject to many exceptions) applies only if the conduct at issue violates both the general and the specific provision. Ans. at 81. But here, there is no claim that Coaltrain's improper communications about the Spector 360 data constituted market manipulation under section 222 and the Anti-Manipulation Rule. *See* Ans. at 81 (no need to show scienter if false statements "are outside of Section 222"); *RadLax Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2072 (2012) (presumption that specific provision overrides general provision applicable only when "the conduct at issue falls within the scope of *both* provisions").[156]

#### d. **The Cases Cited by Peter Jones, Robert Jones, and Jack Wells Under the Federal Rules of Civil Procedure Are Irrelevant Here**

Finally, Peter Jones, Robert Jones, and Jack Wells urge the Commission (Jones Ans. at 27-30) to rely on three cases decided under the Federal Rules of Civil Procedure relating to late productions of documents. But those cases (Jones Ans. at 29 n.111) are

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[155] *Investigation of Terms & Conditions of Pub. Util. Mkt.-Based Rate Authorizations*, 114 FERC ¶ 61,165, at P 43 (2006) (emphasis added).

[156] Coaltrain also argues (Ans. at 79) that it cannot be sanctioned for making false statements made after April 15, 2011, when it no longer had market-based rate authority. That is not correct. The Commission has already in effect rejected the defense that section 35.41(b) only applies to statements made by entities while they had market-based rate authority. For instance, in *Kourouma*, the Commission assessed penalties for section 35.41(b) violations even though the entity, Quntum Energy, did not have market-based rate authority at the time when the false statements were made. *Kourouma*, 134 FERC ¶ 61,105 (2011), *aff'd*, *Kourouma v. FERC*, 723 F.3d 274, 278 (D.C. Cir. 2013). Here, Coaltrain's false statements after April 15, 2011 were made in the context of an investigation into Coaltrain's conduct while it had market-based rate authority. The Commission should expect that entities with market-based rate authority will continue conduct themselves in accordance with the requirements of candor when the Commission investigates what they did while they had market-based rate authority. Surrendering market-based rate authority before making a false statement is not a defense to a duty of candor violation.

about something entirely different: whether late-produced documents should be excluded at trial. Here, the Commission is considering the different question of whether an entity with market-based rate authority complied with its duty of candor in its communications with the Commission. In that context, a later correction—particularly one prompted by staff's own discovery, and not on the entity's own initiative—is not a defense, as *Edison Mission*, *Kourouma*, *City Power*, and *JPMVEC* demonstrate.

## III. Remedies

### A. The Staff Report Characterized The Record Correctly

As they did with the manipulation and section 35.41(b) issues, Respondents dispute some of the facts alleged in the Staff Report. None of these issues is meritorious.

#### 1. The Existence of the Bonus Pool Does Not Mean That the Respondents Were Not Enriched

Respondents dispute (Jones Ans. at 42, Sheehan Ans. at 14) the allegation in the Staff Report that they were enriched by the manipulation because their unjust profits were put into a "FERC dispute bonus pool" that they established when they were dissolving Coaltrain.[157] The purpose of this pool was to pay for their attorneys and for any sanctions, and if any money was left in the pool when the FERC proceeding had concluded, the remainder would be paid out as bonuses to the owners and employees.[158] As an initial matter, it is not the case that they were not enriched simply because they put their unjust profits into a pool to use to hire lawyers to defend this investigation. That is, unjust enrichment is not nullified because the recipients use the proceeds to pay for something (and this is especially true when parties use the proceeds to defend themselves in an investigation of their conduct). Moreover, the amount of money they put into this pool does not actually cover the unjust profits. Jones and Sheehan put only $3.2 million into the "dispute bonus pool," which is approximately $900,000 less than Coaltrain's

[157] Bates No. COALTRAIN012060-61.

[158] *See* Bates No. COALTRAIN012057 at § 3(g), Bates No. COALTRAIN012060-61 at § 7(d), and Bates No. COALTRAIN012067 at Schedule 1.

unjust profits from the scheme.[159] In any event, this pool—which must be much smaller today after paying for legal fees—also shows that Coaltrain does not have the proceeds to pay significant sums by itself in the event the Commission finds a violation and assesses penalties in this proceeding, making joint and several liability particularly appropriate.

### 2. The Staff Report Reasonably Estimated Respondents' Earnings

Respondents also contend (Jones Ans. at 14, 40-42) that the Staff Report's statement about their earnings is incorrect because it cites to their 2010 and 2011 income tax returns, and also because such tax returns could include their spousal income. As to the second point, while it is true that the use of tax returns *may* include spousal income, they have never said that some of the income in the tax returns actually was spousal income. That is, they complain that some of the money *might* be spousal income, but they neither argue nor offer proof that it was, thereby leaving no evidentiary basis to dispute that the income listed on the tax returns is, in fact, their own income. As to the first point, the Staff Report relied on the 2010 and 2011 returns because the bonuses that Coaltrain paid to its employees for 2010 were not necessarily paid until the 2011 taxable year—for instance, the company stated in a data response (dated September 27, 2013) that it had paid one employee a bonus of $414,000 in 2010, but the bonus amount was not reflected in that employee's tax returns until 2011.[160] Accordingly Enforcement properly relied on the 2010 and 2011 returns to get a complete picture of both salary and bonus for 2010.

### 3. The Staff Report Makes Specific Allegations Against Each of The Individual Respondents

Some of the Respondents claim (Jones Ans. at 24-27) that they have not received enough individualized notice to enable them to understand the factual allegations against them. But that is not correct. The Staff Report is full of specific allegations against each

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[159] Bates No. COALTRAIN012060 at § 7(d).

[160] *Compare* Bates Nos. HUGHES00000035 (2010), HUGHES0000082 (2011), and HUGHES0000085 (2010-11 comparison) *to* Coaltrain Resp. to Enforcement Staff Sept. 9, 2013 Subpoena at 4-5, Question No. 3 (Sept. 27, 2013) (listing bonus for 2010).

of the Respondents—for instance, Peter Jones is mentioned by name more than a hundred times in the Staff Report and Order, Robert Jones is mentioned more than 40 times, and Jack Wells is mentioned more than 160 times. The Report includes dozens of allegations regarding statements and other conduct by each of those individuals indicating their primary participation in the common manipulative scheme, which was to plan and execute UTC trades not for a legitimate purpose but rather to collect MLSA payments. Each one of the individuals in the Jones Answer themselves researched and executed OCL trades. In any event, all of the underlying records are available to the Respondents, and it was not necessary to quote every single one in the Staff Report. To be sure, the use of the word "Respondents" does not always mean that every single respondent was involved in every specific incident, but there are more than enough specific allegations in the Report to give each of the individual respondents sufficient notice of what has been alleged against them.

#### 4. Hughes is Named in The Preliminary Findings Letter

Some of the Respondents suggest (Sheehan Ans. at 2 n.2) that Hughes was not named in the Enforcement's Preliminary Findings Letter. But this is incorrect. In fact, Hughes is specifically named as one of the recipients on the letter's first page, along with Coaltrain and the other individual respondents. The mere fact that the letter specifically defined the term "Respondents" to refer to the other individuals is not evidence that Hughes did not receive sufficient notice that the letter preliminarily found that he had participated in the violations.[161]

#### 5. Miller Participated in The Manipulative Scheme

Respondents also contend (Sheehan Ans. at 11-12) that Miller did not direct Wells to make OCL trades, that he was not Wells's superior, and that his suggestion of an OCL trade was innocent. Whatever Miller's position in the organization chart, he directly participated in the OCL scheme by coordinating with Wells and others to ensure that the strategy was implemented, and in his June IM discussion with Sheehan, he demonstrated

[161] Even if Hughes was not included in the Preliminary Findings Letter, it is the Order to Show Cause (including the Staff Report) that is relevant at this stage.

early awareness of what the OCL strategy entailed. *See* Staff Report at 27-28, 40, 76-77, 82, 86, 87, 90. The Staff Report acknowledges that Miller played a lesser role in the scheme than the other individual respondents, however, and this fact is reflected in the smaller recommended penalty.

### B. The Commission Has Legal Authority To Assess The Requested Remedies

#### 1. Joint and Several Liability is Appropriate Here

Sheehan and Jones contend that the Commission lacks authority under the FPA to impose joint and several liability either for disgorgement or for civil penalties. Sheehan Ans. at 21-26, 29-31; Jones Ans. at 30. They are mistaken on both counts.

**Disgorgement**. As the Staff Report explained, the Commission has authority to impose joint and several liability for disgorgement. In *SEC v. Whittemore*, 659 F.3d 1, 10-11 (D.C. Cir. 2011) (cited in Staff Report at 123 & n.510), the D.C. Circuit held that if *either* of two circumstances is present—(1) a "close relationship between the defendants" or (2) "collaboration in the wrongdoing"—it is proper to impose joint and several liability for disgorgement. Here, both circumstances are present. Accordingly, the Commission has authority to hold Jones, Sheehan, and Coaltrain jointly and severally responsible for disgorgement.

**Penalties**. Whether imposition of joint and several liability for penalties is permissible depends on the particular statute being enforced. In this respect, statutes fall into three categories: (a) laws that *require* joint and several liability, (b) laws that *preclude* joint and several liability, and (c) laws that are silent on the issue and, thus, *permit, but do not require*, joint and several liability, leaving agencies and courts discretion about whether to do so.

The first category—statutes that require joint and several liability—includes certain provisions of the tax code.[162] The second category—statutes that preclude joint and several liability—includes (according to some courts) one detailed, highly-

[162] 26 U.S.C. § 6013(d)(3) (2012) ("if a joint return is made, the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several").

prescriptive remedy provision in the securities laws.[163] The third category—statutes that leave the matter to the agency's or court's discretion—includes both the FPA and a variety of other federal laws.

With statutes of this third type, courts routinely impose joint and several liability for civil penalties when doing so is in the interests of justice. This third category of statutes includes the False Claims Act,[164] the Commodities Exchange Act,[165] the Resource Conservation and Recovery Act ("RCRA"),[166] federal housing laws,[167] the Clean Water Act,[168] and at least two portions of the Clean Air Act.[169] The relevant

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[163] *SEC v. Pentagon Capital Mgmt. PLC*, 725 F.3d 279, 288 (2d Cir. 2013) (no joint and several liability for penalties under 15 U.S.C. § 77t(d)(2), because that provision caps penalties at a *specific dollar amount* for each defendant, namely the "gross amount of pecuniary gain to such defendant." (citing 15 U.S.C. § 77t(d)(2)). The FPA contains no such individualized hard cap on penalty amounts, instead merely specifying factors that the Commission shall "take into consideration." FPA section 316A, 16 U.S.C. § 825*o*-1(b). And while the FPA directs the Commission to consider both "the seriousness of the violation" and "the efforts of such person to remedy the violation in a timely manner," that language does not preclude joint and several liability for penalties, particularly when (as is true here) none of the respondents made *any* efforts to remedy the violation. *See* Staff Report at 118.

[164] *E.g.*, *Mortgages, Inc. v. U.S. Dist. Court for Dist. of Nev. (Las Vegas)*, 934 F.2d 209, 212 (9th Cir. 1991) (joint and several liability for statutory penalty); *United States v. Stevens*, 605 F. Supp. 2d 863, 867 (W.D. Ky. 2008) (same).

[165] *E.g.*, *CFTC v. Hunter Wise Commodities, LLC*, 21 F. Supp. 3d 1317, 1353 (S.D. Fla. 2014) (joint and several $55.4 million civil money penalty); *CFTC v. Green Tree Capital*, No. 1:11-CV-10621-JLT, 2013 WL 6979642, at *5 (D. Mass. Oct. 24, 2013) (joint and several $10 million civil money penalty); *CFTC v. iGlobal Strategic Mgmt., LLC*, No. 12 CIV 6574 BSJ, 2012 WL 6930308, at *8 (S.D.N.Y. Nov. 19, 2012) (joint and several $1.8 million civil penalty).

[166] *United States v. Vineland Chem. Co.*, No. CIV. A. 86-1936, 1990 WL 157509, at *10 (D.N.J. Apr. 30, 1990), *aff'd*, 931 F.2d 52 (3d Cir. 1991) ("Defendants are jointly and severally liable for the [RCRA] penalty"); *EPA v. Envtl. Waste Control, Inc.*, 710 F. Supp. 1172, 1245 (N.D. Ind. 1989), *aff'd*, 917 F.2d 327 (7th Cir. 1990) ("a civil penalty of $2,778,000 should be assessed against the defendants jointly and severally").

[167] *Grier v. U.S. Dep't of Hous. & Urban Dev.*, 797 F.3d 1049, 1052 (D.C. Cir. 2015) (affirming imposition by HUD of joint and several penalty of $262,500 against two respondents).

[168] *Cmty. Ass'n for Restoration of Env't (CARE) v. Henry Bosma Dairy*, No. CY-98-3011, 2001 WL 1704240, at *16 (E.D. Wash. Feb. 27, 2001) (joint and several $171,500 civil penalty against defendants), *aff'd*, 305 F.3d 943 (9th Cir. 2002).

[169] At least two separate subparts of the Clean Air Act allow for joint and several liability for civil penalties. *See United States v. B & W Inv. Properties*, 38 F.3d 362, 368-69 (7th Cir. 1994)

provision of the FPA, 16 U.S.C. § 825*o*-1 (2012), is of this third type, neither requiring nor precluding imposition of joint and several liability.

It is also settled that agencies have significant latitude in choosing remedies—including penalties—for misconduct. The leading case is *Niagara Mohawk Power Corp. v. Federal Power Commission*, 379 F.2d 153 (D.C. Cir. 1967), in which the Court of Appeals held that "the breadth of agency discretion is, if anything, at zenith when the action assailed relates . . . to the fashioning of policies, remedies and sanctions . . . ." *Id.* at 159. As the court explained, one area in which "[t]his source of discretion is available" is "where an agency has the explicit power to impose penalties . . . ." *Id.* Here, of course, the Commission does have "the explicit power to impose penalties" under section 222 of the FPA, making *Niagara Mohawk* squarely applicable. The courts have consistently applied the same principles in the years since *Niagara Mohawk* was decided. *See, e.g.*, *Louisiana Pub. Serv. Comm'n v. FERC*, 522 F.3d 378, 393 (D.C. Cir. 2008). The Commission therefore has broad discretion to impose joint and several liability in this proceeding.

### 2. <u>The Commission May Penalize Individuals For Manipulating The Market</u>

All of the individual Respondents dispute that the FPA authorizes the Commission to impose penalties on individuals for violations of the Anti-Manipulation Rule. Jones Ans. at 22-24; Sheehan Ans. at 32-34. In fact, as the Commission has repeatedly held, the FPA gives it that authority.

As Respondents concede, in *FERC v. Barclays Bank PLC*, the U.S. District Court for the Eastern District of California confirmed the agency's long-standing determination that section 222 of the FPA bars fraud by both organizations and individuals.[170] The *Barclays* court was correct, both for the reasons stated in that opinion and for additional reasons discussed below.

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(Section 113); *United States v. Mac's Muffler Shop, Inc.*, No. CIV.A. C85-138R, 1986 WL 15443, at *10 (N.D. Ga. Nov. 4, 1986) (Section 205).

[170] *FERC v. Barclays Bank PLC*, 105 F. Supp. 3d 1121, 1146 (E.D. Cal. 2015).

Section 222 of the FPA, 16 U.S.C. § 824v (2012), bars "any entity" from engaging in "manipulative [behavior] . . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of electric ratepayers." Based on a long-accepted usage of the word "entity" in legal contexts, the logical reading of the text in the context of Congress' goals, and the deference required by *Chevron*, section 222 authorizes FERC to impose liability on individuals for market manipulation.

Sheehan, Miller, and Hughes assert (Sheehan Ans. at 34) that the "unambiguous meaning of 'entity' in FPA section 222 cannot include natural persons." Respondents are incorrect. In fact, both Congress and the courts routinely use "entity" to include individuals. In *City of Abilene v. FCC*, 164 F.3d 49 (D.C. Cir. 1999), for example, the Court of Appeals found that an "entity" can "*include a natural person*, a corporation, a partnership, a limited liability company, a limited liability partnership . . . ." *Id.* at 52 (emphasis added). Similarly, in *Nat'l Family Planning & Reprod. Health Ass'n, Inc. v. Gonzales*, 468 F.3d 826 (D.C. Cir. 2006), the Court of Appeals noted that in the statute under consideration, "the term 'health care *entity*' includes *an individual physician*." *Id.* at 828 (emphasis added). And in *United States v. Grzywacz*, 603 F.2d 682, 687 (7th Cir. 1979), the Court of Appeals held that in the context of the RICO statute, "a police department and *individual police officers are legal entities* and thus qualify as enterprises.") (emphasis added).

Hundreds of cases and statutes use language making clear that, in a legal context, an individual is *a type* of entity. For example, federal courts and Congress regularly use the phrase "individual *or other entity*" in decisions and in statutes. In *Merrell Dow Pharm. Inc. v. Thompson*, 478 U.S. 804 (1986), for example, the Supreme Court stated that "a federal law expresses Congress' determination that there is a federal interest in having *individuals or other entities* conform their actions to a particular norm established by that law." *Id.* at 828. That phrase necessarily means that individuals are a type of "entity." A Westlaw search shows that more than 100 other cases use the phrase "individual or other entity." *E.g.*, *Belhas v. Ya'alon*, 515 F.3d 1279, 1291 (D.C. Cir.

2008) ("The agency relationship is quite different, however, when the *individual or other entity* has served as an organ of the foreign state.") (Williams, J., concurring).

Similarly, courts and Congress frequently use the phrase "person *or other entity*," which likewise necessarily means that individuals (who are unquestionably "persons") are a subset of "entities." In *Texas Dep't of Hous. & Cmty. Affairs v. Inclusive Communities Project, Inc.*, 135 S. Ct. 2507 (2015), for example, the Supreme Court noted that the Fair Housing Act makes it "unlawful for *any person or other entity* whose business includes engaging in real estate-related transactions to discriminate against any person in making available such a transaction . . . because of race, color, religion, sex, handicap, familial status, or national origin." *Id.* at 2518 (emphasis added). A Westlaw search shows that more than 300 cases contain the phrase "person or other entity."[171] Similarly, the Americans with Disabilities Act defines "covered *entity*" to include an "employer," which in turn is defined to be "a *person* engaged in an industry affecting commerce" with certain numbers of employees. 42 U.S.C. § 12111(2), (5)(A) (2012) (emphasis added). Finally, dictionaries likewise use "entity" to include individuals. *E.g.*, Black's Law Dictionary (6th ed. 1990) ("an organization or being that possesses separate existence for tax purposes); West's Encyclopedia of Am. Law (2nd ed. 2008) ("Entity" is "[a] real being; existence. . . . Entity includes person, estate, trust, governmental unit."); American Heritage Dictionary (5th ed. 2011) ("Something that exists as a particular and discrete unit: *persons and corporations are equivalent entities under the law*").

Citing a handful of examples, Peter Jones, Robert Jones, and Jack Wells contend (Jones Ans. at 23-24) that other uses of the term "entity" in statutes implemented by FERC supposedly demonstrate that Congress must have intended "any entity" in section 222 to exclude individuals.

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[171] *E.g.*, *Chamber of Commerce of U.S. v. Whiting*, 563 U.S. 582, 585 (2011) ("The IRCA [Immigration Reform and Control Act] makes it 'unlawful for a *person or other entity* . . . to hire, or to recruit or refer for a fee . . . an unauthorized alien.'"); *Fanning v. Bell*, 82 F. Supp. 3d 60, 63 (D.D.C. 2015) ("The term "beneficiary" is defined in the Plan of Benefits as a *person or other entity* designated by a Participant . . . .").

Respondents are mistaken. In fact, many other provisions of EPAct itself, which included section 222, use the term "entity" to refer to individuals as well as to organizations. Section 1004 of EPAct 2005, codified at 42 U.S.C. § 16394 (2012), for example, requires the Secretary of Energy to conduct outreach to "manufacturers, *consumers, engineers, architects*, builders, energy service companies, institutions of higher education, *facility planners and managers*, State and local governments, *and other entities*." (Emphasis added.) This provision necessarily means that "consumers," "architects," and other natural persons are "entities."

Another provision of EPAct 2005, like the statutory provisions cited above, uses the phrase "person *or other entity*," which necessarily means that individuals (who are "persons") are a type of "entity." In section 394(b)(2) of EPAct 2005 (codified at 42 U.S.C. § 15907), which deals with abandoned wells on federal land, for example, Congress directed the Secretary of Energy to develop a program to recover costs "from *persons or other entities* currently providing a bond or other financial assurance required under State or Federal law for an oil or gas well that is orphaned, abandoned, or idled" (emphasis added). Similarly, as the *Barclays* court noted, section 221 of the FPA, 16 U.S.C. § 824u, enacted as part of EPAct 2005, uses the phrase "*person or any other entity*," again confirming that Congress used "entity" to include individuals. *Barclays*, *supra*, 105 F. Supp. 3d at 1146 (emphasis added).

In still other provisions of EPAct 2005, reading "entity" to exclude individuals would have illogical consequences that Congress could not have intended. For example:

- Although section 1222(c)(1) of EPAct is intended to encourage private financial contributions to development of transmission facilities, the individual respondents' narrow reading of "entity" would inexplicably require the government to reject contributions from individuals.[172]

[172] 42 U.S.C. § 16421(c)(1) (2012) ("In carrying out a Project . . . the Secretary may accept and use *funds contributed by another entity* for the purpose of carrying out the Project.") (emphasis added); *see id.* § 16421(c)(3) ("In carrying out a Project . . . *any costs of the Project not paid for by contributions from another entity shall be collected through rates charged to customers* using the new transmission capability") (emphasis added).

- Respondent's cramped reading would, for no reason, prevent the Commission from relying on individuals to help the Commission achieve "transparency" by disseminating information about the availability and prices of wholesale energy and transmission.[173]

There are many other provisions in EPAct 2005 in which the individual respondents' narrow construction of "entity" would lead to anomalous results.[174]

Reading "any entity" in section 222 to include natural persons is logical given Congress' goal of providing the Commission with strong tools to combat market manipulation in the wake of the Enron scandal. *See Barclays*, 105 F. Supp. 3d at 1146 ("Overall, a meaning of "entity" that includes natural persons appears more consistent with the goals of FPA § 222 and the surrounding statutory scheme.").[175]

Nor do the individual Respondents offer any policy reason why Congress would make that choice. As the *Barclays* court observed, the language of section 222 is similar to that of section 10(b) of the Securities Exchange Act ("SEA"). Yet there is "*no adequate reason* to conclude that Congress would enact an anti-manipulation statute modeled after the SEA, but *preclude enforcement against persons who engaged in manipulative trading*." *Barclays*, 105 F. Supp. 3d at 114 (emphasis added). Nor is there any reason Congress would impose *criminal* penalties on individuals for violations of the FPA's prohibition against market manipulation (*see* 16 U.S.C. § 825o(a)) and of the

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[173] 16 U.S.C. § 824t(a)(3)(B) (2012) ("The Commission may . . . (B) rely on *entities other than the Commission* to receive and make public the information . . . .") (emphasis added).

[174] For example, reading "entity" to exclude individuals would irrationally (i) bar the Secretary of Energy from cooperating with individuals to educate the public about energy efficiency, EPAct §132, 42 U.S.C. § 6307 (2012), (ii) prohibit the Secretary from consulting with individual experts about building standards, EPAct § 914, 42 U.S.C. § 16194 (2012), and (iii) prevent the Secretary from cooperating with knowledgeable individuals in studying coal mining technologies. EPAct § 964, 42 U.S.C. § 16294 (2012).

[175] In addition, section 18 of EPAct 2005, 15 U.S.C. § 717s (2012), prohibits trading by "individuals" who have violated the Natural Gas Act's ("NGA's") anti-fraud provision (15 U.S.C. § 717c-1), which, like FPA § 222, applies to "any entity." Because the NGA provision treats individuals as "entities," the FPA's parallel provision (enacted the same day) must be read identically. *See Fed. Power Comm'n. v. Sierra Pac. Power Co.*, 350 U.S. 348, 353 (1956) (substantively identical provisions of FPA and NGA should be construed *in pari materia*).

Commission's Anti-Manipulation Rule (*see* 16 U.S.C. § 825o(b)), but exempt individuals from *civil* liability for fraud and market manipulation.

Finally, the Commission's determination is entitled to *Chevron* deference: even if the term "any entity" could be read either to include or to exclude individuals, the Commission is permitted to adopt a reasonable interpretation consistent with its long experience and expertise administering the FPA. *See Chevron U.S.A., Inc. v. Natural Resources Def. Council*, 467 U.S. 837, 843 (1984) (citations omitted). Even in a proceeding with de novo review, deference to the agency's body of precedent is still appropriate. *See United States v. Haggar Apparel Co.*, 526 U.S. 380, 391 (1999) ("De novo proceedings presume a foundation of law. The question here is whether the regulations are part of that controlling law. Deference can be given to the regulations without impairing the authority of the court to make factual determinations, and to apply those determinations to the law, de novo"). And as the Supreme Court recently emphasized in *City of Arlington v. FCC*, 133 S. Ct. 1863, 1874-75 (2013), *Chevron* deference extends to all ambiguities in a statute, even those that an enforcement subject might try to characterize as "jurisdictional" (like the meaning of "any entity" in FPA § 222). *Id.* at 1874-75.

For all of these reasons, the Federal Power Act authorizes the Commission to assess a penalty against the individual respondents for market manipulation.

### 3. <u>The Penalties Against Coaltrain Can be Applied to Jones and Sheehan</u>

Finally, some of the Respondents argue (Sheehan Ans. at 31-32) that the penalties against Coaltrain do not differentiate between the penalties for manipulation and the penalties for the false statements violation. They state that the penalties should be itemized because the penalties for section 35.41(b) violations cannot be assessed jointly and severally against individuals. Respondents misunderstand the penalty analysis. The Staff Report did *not* assess a separate set of penalties for the section 35.41(b) violations. Rather, it explained that Coaltrain's section 35.41(b) violations and the individual Respondents' false and misleading statements and uncooperative behavior together

satisfy the Commission's criteria for the "Obstruction of Justice" aggravating factor. Staff Report at 117. The Staff Report noted that the ordinary Penalty Guidelines calculation does not apply to this proceeding because the company committed violations of two separate Guidelines chapters. Staff Report at 119-20. The Staff Report then included an extensive analysis of the statutory penalty factors in reaching the recommendation for Coaltrain. Staff Report at 120-23. However, as the Staff Report also noted, if the Guidelines calculation would be applied to Coaltrain, it would not treat the section 35.41(b) violation as a standalone source of penalties, but rather the Obstruction of Justice factor would be applied to aggravate the manipulation penalties. Staff Report at 120 n.500. Thus the penalties against Coaltrain are not for section 35.41(b), but instead are for market manipulation, and the Commission may apply the aggravated manipulation penalties to the company and to the individuals alike.

## IV. Respondents Misunderstand the FPA's Procedures

Finally, the Respondents raise a number of claims about the Commission's authority to conduct this proceeding. In particular, they claim that the Order to Show Cause process is *ultra vires*, that the Commission cannot assess penalties because it cannot resolve disputed facts in this particular proceeding, and that if the Commission does assess penalties, the dispute must be adjudicated in a trial before a federal district court. Respondents' arguments reflect a mistaken understanding of the FPA's procedures and of the Commission's enforcement process.

### A. Respondents' FPA Section 31(d)(3) Election

As an initial matter, Respondents' misreading of the law has caused them to select an avenue under FPA section 31(d) that does not guarantee them an opportunity for discovery and a hearing, even though they say that is what they want. This follows two basic misapprehensions. First, they argue (Ans. at 82) that they would not be "guaranteed discovery rights or a trial" under the procedures of section 31(d)(2) because the Order to Show Cause included standard language (OSC at P 5) that "[i]f Respondents elect an administrative hearing before an ALJ, the Commission will issue a hearing order unless it is determined that the matter can be resolved in a summary disposition."

Second, they argue (Ans. at 82-83) that merely by selecting the procedures of section 31(d)(3), penalties cannot be assessed against them because, they say, the Commission cannot resolve what they claim are the disputed facts. The Respondents are wrong.

As to the first proposition—that the procedures of section 31(d)(2) do not guarantee live testimony because the matter might be subject to summary disposition—the Respondents' concern is misplaced because parties are not *guaranteed* a hearing in any forum (administrative or judicial) if there are no genuine disputes of material fact. That is why the Commission summarily disposed of *Kourouma*.[176] The Commission's rule for summary disposition (Rule 217) is neither novel nor materially different from what applies in district court. In fact, Rule 217 is closely modeled on the Federal Rules. *Compare* 18 C.F.R. § 385.217(b) (a matter may be summarily disposed if "there is no genuine issue of fact material to the decision of a proceeding or part of a proceeding") *to* Fed. R. Civ. P. 56 (summary judgment must be granted if "there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law."). Therefore, respondents to orders to show cause are not guaranteed hearings any more than are parties to cases originally filed in district court; however, such respondents are in fact *guaranteed an opportunity* for an administrative hearing under the procedures of section 31(d)(2), while they have no such guarantee if they choose section 31(d)(3) in which a district court reviews the Commission's order. Put simply, if the Respondents here select the procedures of section 31(d)(2) (which, at present, they have not done), and if (as they argue) there are genuine issues of material fact in dispute, then they would get a hearing with live testimony consistent with Commission rules and practice.

The Respondents also incorrectly argue that the Commission is foreclosed from assessing penalties here simply because they selected the procedures of section 31(d)(3). Their premise appears to be twofold: (1) their belief that the Commission cannot resolve genuine disputes of material fact as a matter of law, and (2) their contention that there are genuine disputes of material fact here. Ans. at 83. This overly-clever interpretation is

[176] *Moussa I. Kourouma d/b/a Quntum Energy LLC*, 134 FERC ¶ 61,105 (2011), *aff'd*, *Kourouma v. FERC*, 723 F.3d 274, 278 (D.C. Cir. 2013).

based on the irrational proposition that in section 31(d)(3), Congress enacted a "gotcha!" clause that effectively nullifies the Commission's authority to assess penalties whenever any material facts are in dispute. That is plainly not the case. The FPA establishes two avenues after the Commission initiates a proceeding by issuing an order to show cause and notice of proposed penalty pursuant to section 316A, and the respondents are given the choice. The default avenue of section 31(d)(2) provides for an administrative hearing to resolve disputed facts and law in the first instance under the Administrative Procedure Act, while section 31(d)(3) allows the respondent to forego the opportunity for a hearing in exchange for having a district court review the Commission's order assessing penalties. However, in foregoing a hearing, the respondent is necessarily foregoing any objection to the Commission doing what must be done, that is make a determination based on the record. The Commission has the authority and the obligation to carry out its duties under both section 31(d)(2) and section 31(d)(3). Since the FPA provides that it is the Commission that must assess penalties in the first instance, that means that whenever an entity selects the procedures of section 31(d)(3), the Commission will determine whether a violation occurred—resolving factual disputes as necessary—and, if a violation did occur, decide whether to assess penalties and in what amount.

### B. <u>The Commission Has Authority to Conduct This Proceeding</u>

Respondents Sheehan *et al.* contend that "FERC has no statutory authority to issue an order to show cause directing the subjects of an investigation to show cause that they should not be found to have violated the Commission's rules." Sheehan Ans. at 34. This is so (as they argue) because "[t]he show cause process is not [the] public hearing process" required by FPA section 316A, 16 U.S.C. § 825*o*-1. "Rather, it is an unauthorized administrative artifice that improperly shifts FERC's burden to investigate areas of potential violations and to build and prove its *prima facie* case against the subjects of an investigation on to those subjects. In short, the accused are tasked with proving their innocence." *Id*. at 34. Each of these assertions is wrong.

### 1. <u>This Proceeding is Not *Ultra Vires*</u>

To begin with, the Commission's statutory authority to conduct show cause proceedings is express in the statute. Under section 31(d), the Commission's penalty assessments must be made "by order." 16 U.S.C. §§ 823b(d)(2)(A) ("the Commission shall assess the penalty, by order, after a determination of violation has been made on the record after an opportunity for an agency hearing pursuant to section 554 of title 5, United States Code, before an administrative law judge . . ."), § 823b(d)(3)(A) ("the Commission shall promptly assess such penalty, by order, after the date of the receipt of the notice . . . of the proposed penalty"). The Administrative Procedure Act defines "order" as "the whole or part of a final disposition whether affirmative, negative, injunctive, or declaratory in form of an agency on a matter," and defines "adjudication" as "an agency process for the formulation of an order." 5 U.S.C. § 551(6)-(7).

In other words, the Commission must conduct an adjudication prior to assessing penalties for violations of Part II of the FPA. The statute is clear about what facts need to be adjudicated, namely: (i) whether there was a "violation," (ii) its seriousness, and (iii) "the efforts of [the respondent] to remedy the violation in a timely manner." Section 316A(b), 16 U.S.C. § 825*o*-1(b). Fact-finding is the necessary prerequisite of any such penalty assessment, regardless of which subparagraph of section 31(d) is elected.

While section 31(d)(2) prescribes specific procedures to be employed in such fact-finding and section 31(d)(3) does not, the Commission has the authority to establish such procedures as are necessary and appropriate to fulfill its statutory mandate: "The Commission shall have power to perform any and all acts . . . as it may find necessary or appropriate to carry out the provisions of this Act." 16 U.S.C. § 825h. The Supreme Court has emphasized that, where statutes provide only limited procedural instructions, "agencies 'should be free to fashion their own rules of procedure and to pursue methods of inquiry capable of permitting them to discharge their multitudinous duties.'" *Vermont Yankee Nuclear Power Corp. v. Natural Res. Def. Council, Inc.*, 435 U.S. 519, 543 (1978) (quoting *FCC v. Schreiber*, 381 U.S. 279, 290 (1965)), *and see Dia v. Ashcroft*, 353 F.3d 228, 236-38 (3d Cir. 2003) (*en banc*) (upholding appeals procedures for agency

adjudication in the face of Constitutional and statutory challenge on the grounds that, where the statute did not specify procedures, the agency was free to develop its own procedure as long as they are consistent with the terms of the statute and due process). Indeed, the Supreme Court specifically held that this agency should be free to "exercise its administrative discretion in deciding how, in light of internal organizational considerations, it may best proceed to develop the needed evidence" and how to reflect that evidence in its decisions. *Vermont Yankee*, 435 U.S. at 544 (citing *FPC v. Transcontinental Gas Pipe Line Corp.*, 423 U.S. 326, 333 (1976)); *see also Towns of Concord, Norwood, and Wellesley, Mass. v. FERC*, 955 F.2d 67, 76 (D.C. Cir. 1992) ("The Commission has the primary responsibility for deciding matters concerning enforcement . . . Agency discretion is often at its 'zenith' when the challenged action relates to the fashioning of remedies. *Niagara Mohawk Power Corp. v. FPC*, 379 F.2d [153] at 159 [(D.C. Cir. 1967)]. Here Congress simply directed the Commission to order what it considered 'necessary or appropriate' in each case to carry out the statute's commands."). This authority is reflected in the Commission's regulations. *See* 18 C.F.R. § 1b.7 ("Where it appears that there has been . . . a violation of any of the provisions of the acts administered by the Commission or the rules, opinions or orders thereunder, the Commission may institute administrative proceedings . . . or take other appropriate action."). In this regard, the Commission has the authority to fashion the proper procedure to use when required by a respondent's election of the section 31(d)(3) option.

Contrary to Respondents' unsupported assertion (Sheehan Ans. at 34), the show cause process is indeed the public hearing process required by section 316A. This is confirmed by both the text and the context of the statute. The show cause process is commenced with the order to show cause and notice of proposed penalty, which is the statutorily-required notice under FPA section 316A—and therefore it is the date on which the Commission's FPA penalty actions commence (regardless of whether the respondents subsequently elect the procedures of section 31(d)(2) or 31(d)(3)). Order to Show Cause at P 5 ("This order . . . is the notice of proposed penalty required pursuant to section 31 of the FPA") (citing 16 U.S.C. § 823b(d)(2012)); *see also* FPA section 220(e)(1), 16 U.S.C.

§ 824t(e)(1) (noting that the statute of limitations specific to that section is satisfied on "the date on which the person is provided notice of the proposed penalty under section 316A"). That notice thus triggered the Commission's procedures for assessing penalties under Part II of the FPA and commenced an adversarial proceeding under the Commission's Rules of Practice and Procedure.[177] The Commission has determined that the show cause process is "necessary or appropriate to carry out the provisions of the Act." 16 U.S.C. § 825h, *and see Statement of Administrative Policy Regarding the Process for Assessing Civil Penalties*, 117 FERC ¶ 61,317, at P 4 (2006) (stating that the "goal is to provide procedures that meet applicable statutory requirements and to give entities subject to possible civil penalties due process, in as uniform a fashion as possible . . . before a penalty assessment is made") and 2 ("while this Statement outlines the basic procedures to be followed, we retain the right to modify these procedures to fit the circumstances presented by specific cases, while still providing process that meets the applicable statutory criteria.").

### 2. <u>This Proceeding Does Not Impermissibly Shift the Burden of Proof</u>

As for Respondents' contention that the Commission's show cause procedure "improperly shifts FERC's burden to investigate areas of potential violations and to build and prove its *prima facie* case against the subjects of an investigation onto those subjects" and burdens "the accused . . . with proving their innocence,"(Sheehan at 34), Respondents are mistaken. In show cause proceedings, the order to show cause "does not indicate Commission adoption or endorsement of the Enforcement Staff Report."[178] It does, however, reflect that Enforcement has, in its Staff Report, made out a facially plausible case that Respondents committed the violation in question. The order to show cause procedure then gives Respondents the opportunity to rebut the factual and legal grounds for staff's case as set forth in the Staff Report. *See Barclays Bank, PLC et al.*,

[177] Order to Show Cause at P 1; Notice of Designation of Commission Staff as Non-Decisional (issued Jan. 6, 2016).

[178] Order to Show Cause at P 2.

144 FERC ¶ 61,041, at P 17 (2013). For the reasons detailed throughout this Reply, Respondents have failed to rebut the prima facie case set forth in the Staff Report and supported by credible and credited evidence.

### C. The Commission Has a Duty To Apply Reasoned Decisionmaking Before Finding Violations And Assessing Penalties

Next, the Respondents contend that the Commission cannot "legitimately ask a district court to resolve material factual issues solely on a written record" and that the law requires that they have a full trial in district court. They are incorrect. While the district court (if this matter goes to a district court) will make its own determination about the appropriate procedures to apply if is it called upon to review a penalty assessment order, the suggestion that the Commission cannot resolve disputed facts in the first instance and therefore may not assess penalties is erroneous.

#### 1. The Commission Assesses Penalties in the First Instance

First, section 316A of the FPA authorizes the Commission to assess penalties for violations of Part II of the FPA—including FPA section 222, which prohibits market manipulation—and of "any rule or order thereunder," such as Part 1c and section 35.41(b). It provides that the Commission shall assess such penalties, by order, in accordance with specific statutory criteria. In assessing penalties, the Commission must first find a violation, and then it must assess the "seriousness" of the violation and the effort to remedy or mitigate the violation. The FPA does not authorize a district court to find violations or assess penalties for such violations in the first instance. Nor is the district court action contemplated by the statute to be an original or new action; rather the statute's plain language authorizes only a "review" of the facts and the law involved in the Commission's order finding violations and assessing penalties.

As the procedural provisions of the Act make clear, Congress intended the Commission to make substantive conclusions about the "the law and the facts involved" for a court to "review" (re-examine)[179] "de novo" (anew)[180] to decide whether to

[179] 16 U.S.C. § 823b(d). *See* Black's Law Dictionary 1186 (5th ed. 1979) (definition of "review") ("To re-examine judicially or administratively; a reconsideration; second view or

"affirm"[181] an order "assessing" (directing to pay)[182] penalties. 16 U.S.C. § 823b(d)(3)(B). And since Congress intended FERC to explain its conclusions, it is necessary and appropriate for the agency to prepare, and to provide the court with, the evidence and arguments the agency considered, *i.e.*, the administrative record.[183]

Second, the statute provides that the Commission shall impose its penalties "after notice and opportunity for public hearing." The "Notice" is the "Notice of Proposed Penalty" that the Respondents received. It does not say "after public hearing," but only merely "after . . . *opportunity* for public hearing." (emphasis added). There is no question that Respondents have been given an *opportunity* for a public hearing: the procedures of section 31(d)(2) (which Respondents explicitly and in writing declined to avail themselves of) are, per the Administrative Procedure Act, procedures for a formal public hearing. And when a respondent elects for the procedures of section 31(d)(3), the "opportunity for public hearing" requirement of the Act is satisfied because the Commission's procedures under that section are public hearings, and also because there was an opportunity for an administrative hearing that the respondent elected to forego.

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examination; revision; consideration for purposes of correction. Used especially of the examination of a cause by an appellate court or an appellate administrative body (*e.g.* Appeals Council in social security cases)"); *see also* Black's Law Dictionary (5th ed. 1979), Am. Heritage Dictionary (5th ed. 2013): "1. To look over, study, or examine again: *reviewed last week's lesson* . . . . 5. *Law* To evaluate (a decision made 2013); Merriam-Webster Collegiate Dictionary 1067 (11th ed. 2005) ("to examine or study again; *esp*: to reexamine judicially").

[180] "De novo" means "[a]new; afresh; a second time." Black's Law Dictionary 392 (5th ed. 1979); *see* Am. Heritage Dictionary (5th ed. 2013) ("Over again, anew"); Merriam-Webster Collegiate Dictionary 333 (11th ed. 2005) ("over again: ANEW").

[181] "Affirm" means to "ratify, uphold, approve, make firm, confirm, establish, reassert." Black's Law Dictionary 59 (6th ed. 1990).

[182] FPA § 31(d) applies to this matter because of FPA § 316A (16 U.S.C. § 825*o*-1). Courts have found that the power to "assess" a penalty under FPA § 316A "confer[s] . . . power to *impose* monetary penalties for violations . . . ." *Southwest Power Admin. v. FERC*, 763 F.3d 27, 30 (D.C. Cir. 2014) (emphasis added). In addition, Congress has used "assess" and "impose" interchangeably in other statutes. *E.g.*, 15 U.S.C. § 2615 (2012).

[183] The Federal Power Act explicitly authorizes the Commission to conduct hearings, which "shall be governed by rules of practice and procedure to be adopted by the Commission" and to compile "appropriate records" of such hearings. 16 U.S.C. § 825g.

Finally, since it is the Commission that assesses the penalties in the first instance, the "public hearing" referenced in the statute is the procedures undertaken (under either election) at the Commission; it cannot mean a proceeding in district court, which would occur only after the Commission has issued an order finding a violation and assessing civil penalties.

### 2. The Commission May Adjudicate Disputes of Material Fact in a Paper Hearing

As discussed above, under the statutory structure of the FPA, it is the Commission's responsibility in the first instance to assess penalties for violations of Part II of the Act. It can only impose such penalties after adjudicating the question of whether a violation has been committed—which, in the case of violations of FPA section 222 and Part 1c, necessarily includes adjudicating respondents' scienter. The Commission does not, as Respondents seem to suggest (Ans. at 90), have authority to delegate that responsibility to a district court. Nor does the district court have authority to make an initial penalty assessment; on the contrary, it is authorized only to "review" the facts and the law underlying the Commission's penalty assessment.

Respondents contend that they can upend this statutory structure by preventing the Commission from discharging its responsibilities under the Act simply by electing FPA section 31(d)(3) procedures and then claiming that no penalty can be assessed without live testimony. Respondents contend that scienter—indisputably a necessary element of finding a violation of Section 222 of the FPA and 1c of the Commission's Regulations—hinges on a determination of "credibility," which "cannot [be] properly assess[ed]" in the absence of live testimony. Ans. at 82-83.[184] They claim that "the Commission will have

[184] Seeking to support this argument, Respondents cite authorities that are not on point. They contend, citing *Snyder v. Louisiana*, 552 U.S. 472 (2008) (*Snyder*) and *United States v. Rem*, 38 F.3d 634 (2d Cir. 1994) (*Rem*), that credibility is a matter for a trial judge or a jury, respectively. But neither of these cases supports that argument: *Snyder* involved the review of a claim that a prosecutor illicitly exercised his peremptory juror challenges on the basis of race. Under the applicable legal standard, the trial court's evaluation of the demeanors of both prosecutor and prospective juror are critical to determining whether the peremptory juror challenge was impermissibly based on race. *Snyder*, 553 U.S. at 476-476. In *Rem*, which reversed an order granting summary judgment, the court's order simply stated the truism that, "[o]n a motion for

summary judgment, the court is not to weigh the evidence, or assess the credibility of the witnesses, or resolve issues of fact, but only to determine whether there are issues to be tried," so to the extent that a court is presented with such issues, they "are matters for the jury, not for the court on summary judgment." *Rem*, at 644. These propositions are true as far as they go, but also irrelevant to the issues presented in this case, which is not before the Commission on a motion for summary judgment.

Respondents also invoke *Cram v. Sun Ins. Office, Ltd.*, 375 F.2d 670 (4th Cir. 1967) ("*Cram*") and *United States v. Polly*, 630 F.3d 991 (10th Cir. 2011) ("*Polly*") for the proposition that "credibility . . . is a factual issue." Ans. at 83 & n.343. These cases do not provide support either: *Cram* involved cross motions for summary judgment in "a many-faceted lawsuit [as to which] only one facet has as yet been resolved." *Cram* at 673. The Court of Appeals consequently held that an appeal of that partial disposition "must be dismissed as premature" under Fed. R. Civ. P. 54(b). *Id*. That rule does not apply here.

*Polly* turned on defendant's claim that he was entitled to a new trial because "his counsel failed to investigate and bring forward certain evidence that was relevant" to an issue in the case. *Polly* at 1003. The Court of Appeals found that Polly should have developed his ineffective assistance of counsel claim by motion for a collateral proceeding before the trial court, rather than on direct appeal. *Id*. This case has nothing to do with the issues now before the Commission.

Respondents' invocation of *Grandon v. Merrill Lynch & Co*., 147 F.3d 184 (2d Cir. 1998) ("*Grandon*") is also misplaced: Respondents cite *Grandon* to support the proposition that "[w]hether Respondents have acted with 'scienter' is a 'question of fact,' the resolution of which requires live testimony and credibility determinations by a disinterested decisionmaker." Coaltrain Answer at 82-83, and 91 (same). That is not what *Grandon* stands for. In *Grandon*, the Second Circuit found that a broker-dealer could be liable for fraud and subject to a private cause of action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, for charging excessive markups on municipal bond sales and failing to disclose such markups. The court below had simply dismissed the complaint on the grounds that Merrill Lynch was not under any obligation to disclose the markups. *Grandon*, 147 F.3d at 187-188. Although neither the SEC nor the Municipal Securities Rulemaking Board ("MSRB"), a self-regulatory organization, had provided any benchmarks or guidance for what constitutes "excessive" markups, and although there was no law, regulation, or rule requiring the disclosure of markups for municipal bond sales, the Second Circuit Court of Appeals nonetheless held that such a duty to disclose exists. Extending the logic of prior decisions, the Court of Appeals held that "there exists an implied duty to disclose markups on municipal securities when those markups are excessive," *id*. at 193 (citation omitted), and vacated the trial court's finding that "Merrill Lynch did not act with scienter because . . . [it] had no duty to disclose even excessive markups." *Id*. at 194. Even on remand, the District Court declined to address the *scienter* question. Because it held that the complaint was deficient for failure to analyze each of the qualitative factors set forth by MSRB for evaluating markups, the court held that the complaint had failed to state fraud with sufficient particularity to satisfy Fed. R. Civ. P. 9(b). *Grandon ex rel. Grandon Family Irrevocable Trust v. Merrill Lynch & Co., Inc.*, 1999 WL 993653 at ** 4-5 (S.D.N.Y. 1999) (Not Reported).

no such opportunity in this case" (though they do not acknowledge that they are the ones who rejected an administrative hearing, not the other way around). Ans. at 91-92. In short, Respondents contend that they can trigger the requirement that the Commission assess credibility by "expressly" disputing "[m]otive, intent, and credibility" (Ans. at 83) while simultaneously preventing the Commission from fulfilling that requirement through their election of FPA section 31(d)(3) procedures.

This is meritless. As discussed above, the statute and its purposes are not so easily frustrated. Respondents have always had the ability to have the issues in this case tried through formal adjudicative proceedings before an ALJ under FPA section 31(d)(2). And Enforcement has explicitly stated that it would not oppose a request by Respondents to revoke their election of section 31(d)(3) procedures (Enforcement Staff Feb.17, 2016 Response to Respondent's Notice of Election), though the Commission would still need to approve such a request. 16 U.S.C. § 823b(d)(3)(C).

Respondents' section 31(d)(3) election does not mean that the Commission cannot fulfill its obligation under the statute. Rather, the Commission has the authority to resolve disputed facts based on the abundant record here and the parties' voluminous submissions. The investigative record here includes hundreds of thousands of screenshots and well over ten thousand pages of the Respondents' own documents, in addition to seven sets of transcribed testimony, multiple reports from the Respondents' consultant, declarations by each of the Respondents, uncontroverted trade data covering all of the trades in question, and numerous documents and data submitted by third parties. And although factual disputes would not prevent the Commission from resolving the matter, this case is particularly easy because the Respondents do not genuinely dispute the core facts of this matter. For instance, they do not dispute that they did the OCL trades in question, or that the OCL trades made no money but for MLSA payments, or that "OCL" refers to MLSA payments, or that they possessed but did not review or produce the Spector 360 records. The only core dispute here as a practical matter is whether their trades were done to profit from price differences or to profit from MLSA payments. In any event, because it was the Respondents themselves who elected to

forego an administrative hearing in this matter, they also relinquished their objections to the Commission fulfilling its statutory obligations by making a determination after reviewing the record and considering the parties' arguments.[185]

In sum, the Commission may decide disputed facts when it is necessary and appropriate to do so. This is such a case: not only have Respondents voluntarily selected a procedure that requires the Commission to make a determination on the paper record, but the evidence is clear and overwhelming that they engaged in a scheme to manipulate the market and that Coaltrain made numerous false and misleading statements.

### 3. The Seventh Amendment Does Not Prevent The Commission From Performing Its Lawful Duties

Citing *Tull v. United States*, 481 U.S. 412 (1987), Respondents contend that the Seventh Amendment entitles them to a jury trial. Ans. at 82. Respondents are incorrect. While parties in civil penalty cases that *begin* in federal court have a jury trial right, there is no such right when, as here, an agency conducts an administrative proceeding that is subject to later judicial review.

In *Tull*, the EPA sought to obtain relief for violations of rules relating to wetlands. Unlike here, the EPA had not previously conducted its own proceeding against the landowner, but simply filed an original case in court, seeking (among other things) civil

[185] In addition to the fact that the Commission must (if necessary) resolve factual disputes in penalty proceedings, whether the respondent chooses to proceed under section 31(d)(2) or section 31(d)(3), and that it was the Respondents themselves who chose this procedural path, it has long been settled that courts and agencies may, regardless of demeanor, decline to accept factual claims that are "blatantly contradicted by the record," *Scott v. Harris*, 550 U.S. 372, 380 (2007). In *Scott*, the Supreme Court held that in ruling on a motion for summary judgment, a court can reject, without a hearing, testimony that is incredible in light of other evidence. (The factual claims in *Scott* were contradicted by a videotape. *Id.* at 380.) The lower courts have applied that principle many times in granting (or affirming the grant of) summary judgment. *E.g.*, *Medina-Rivera v. MVM, Inc.*, 713 F.3d 132, 139-40 (1st Cir. 2013) (affirming summary judgment when witness' claim not to have worked during a certain period was contradicted by earnings statements); *Rojas v. Roman Catholic Diocese of Rochester*, 660 F.3d 98, 105 (2d Cir. 2011) (affirming summary judgment when plaintiff's new factual contentions inconsistent with written record); *Marksmeier v. Davie*, 622 F.3d 896, 900 (8th Cir. 2010) (affirming summary judgment when party's factual assertions were contradicted by his statements in interview).

penalties. *Id.* at 414. In that context, the Court held that the Seventh Amendment gave the landowner a right to a jury trial to determine his liability for civil penalties (although not their amount). *Id.* at 417-27.

Here, by contrast, the agency is conducting an administrative proceeding to resolve the matter. In this context, the Seventh Amendment does not require a jury trial. The leading case is *Atlas Roofing Co. v. Occup. Safety & Health Review Comm'n*, 430 U.S. 442 (1977), in which the Court considered whether the Seventh Amendment allowed agencies to resolve occupational health violations, subject to judicial review without a jury. The Court held that "[a]t least in cases in which 'public rights' are being litigated," *i.e.*, when "the Government sues in its sovereign capacity to enforce public rights created by statutes within the power of Congress to enact," Congress may "assign[] the fact-finding function and initial adjudication to an administrative forum with which the jury would be incompatible." *Id.* at 450. The present case, of course, is a governmental proceeding to vindicate public rights created by statute.

The *Tull* Court endorsed *Atlas Roofing*'s holding that "the Seventh Amendment is not applicable to administrative proceedings." *Tull*, 481 U.S. at 418 n.4. And lower courts have applied the case in several contexts. In *Sasser v. EPA*, 990 F.2d 127 (4th Cir. 1993), for example, the court rejected a jury trial claim after Congress amended the Act to provide for agency resolution of the EPA's claims. Similarly, courts have upheld the Multiemployer Pension Plan Amendments Act ("MPPAA"), which require firms to pursue their claims through arbitration, followed by court review without a jury. *See e.g.*, *Washington Star Co. v. Int'l Typographical Union Negotiated Pension Plan*, 729 F.2d 1502, 1511 (D.C. Cir. 1984).

In the cases finding no jury trial right in administrative proceedings, the agency's determinations were, as here, subject to judicial review. In *Atlas Roofing*, for example, while the agency did the "initial adjudication," *id.* at 450, its decisions were subject to review by the Court of Appeals, *id.* at 446-47. Similarly, under the MMPPA, awards by arbitrators could be "enforce[d], vacate[d], or modif[ied]" by a federal district court. 29 U.S.C. § 401(b)(2) (2012). In *Sasser*, the EPA's determinations in an administrative

proceeding were subject to review by the Court of Appeals. *Id.* at 128. And in one of the Supreme Court cases discussed in *Atlas Roofing*, the IRS' administrative assessment of a penalty was subject to later judicial review, without participation by a jury at any stage. *Helvering v. Mitchell*, 303 U.S. 391, 395 (1938).

### D. <u>The District Court's Review Proceeding Does Not Require a Full Trial</u>

As a final matter, the Respondents contend (Ans. at 92) that the statute requires that they have a full trial on the merits in district court. But as discussed above, the Seventh Amendment does not require juries in cases where the district court is conducting a review of an administrative proceeding. And as the Commission has consistently stated in numerous recent filings around the country,[186] and as Enforcement stated earlier in this proceeding, district courts are vested with substantial discretion in determining the proper procedures to apply in a review proceeding under section 31(d)(3), and neither the Constitution nor Congress require full trials in this context. Enforcement Staff Feb. 17, 2016 Resp. to Notice of Election at 1. Accordingly, if this matter goes to a district court, that court will decide for itself what procedures are necessary and appropriate to assist its review of the Commission's order.

[186] *See FERC v. Barclays Bank PLC, et al.*, Case No. 2:13-cv-02093-TLN-EFB (E.D. Cal.); *FERC v. Silkman, et al.*, Case No. 1:13-cv-13054-DPW (D. Mass.); *FERC v. Lincoln Paper and Tissue, LLC*, Case No. 1:13-cv-13056-DPW (D. Mass.); *FERC v. Maxim Power Corp., et al.*, Case No. 3:15-cv-30113-MGM (D. Mass.); *FERC v. City Power Marketing, LLC, et al.*, Case No. 1:15-cv-01428-JDB (D.D.C.); *FERC v. Powhatan Energy Fund, LLC, et al.*, Case No. 3:15-cv-0452 (MHL) (E.D. Va.).

## V. Conclusion

For the reasons stated above and in the Staff Report, the Commission should find that the Respondents devised and executed a joint scheme to manipulate the PJM market by planning and placing UTC trades designed to profit from the collection of MLSA payments rather than from fundamental price spreads. The Commission also should find that Coaltrain violated section 35.41(b) of the Commission's regulations by repeatedly providing false and misleading statements and material omissions to Commission staff and to the IMM. After finding these violations, the Commission should disgorge unjust profits and assess penalties under section 316A of the FPA in the nature and amounts discussed in the Staff Report and in this Reply.

Respectfully submitted

/s/

_____

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## CERTIFICATE OF SERVICE

I hereby certify that I have today arranged for the foregoing document and non-public attachment to be served on counsel for all Respondents in this matter.

Dated this 1st day of April, 2016.

/s/

James Owens
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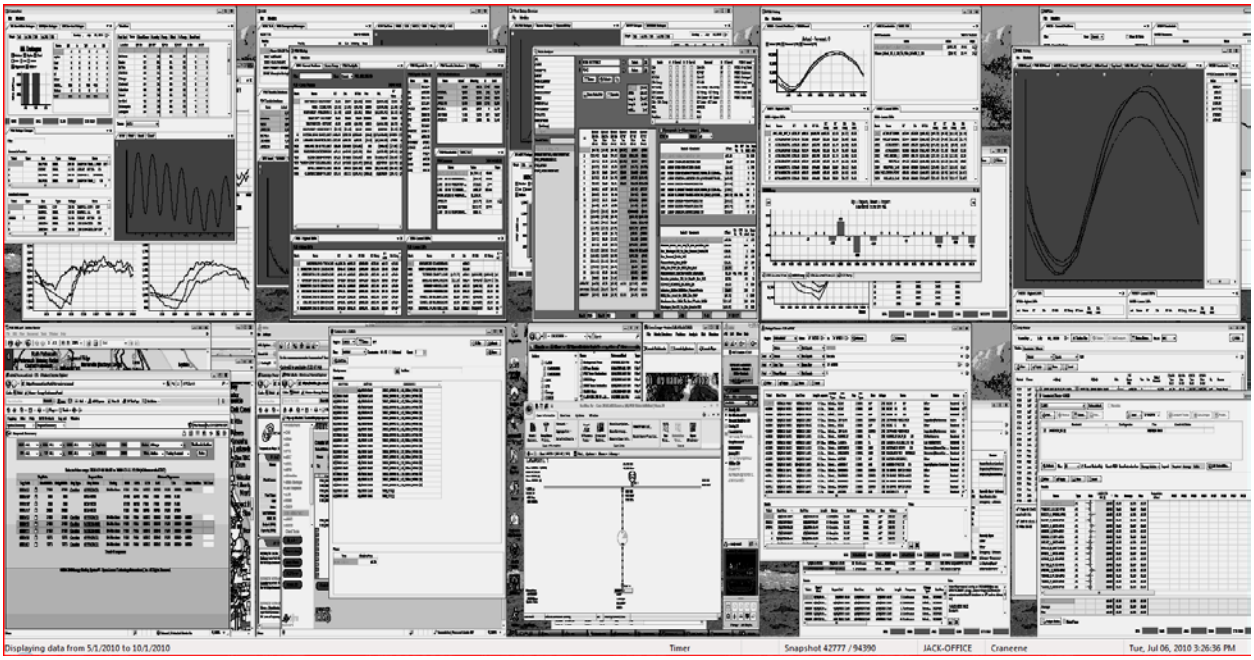
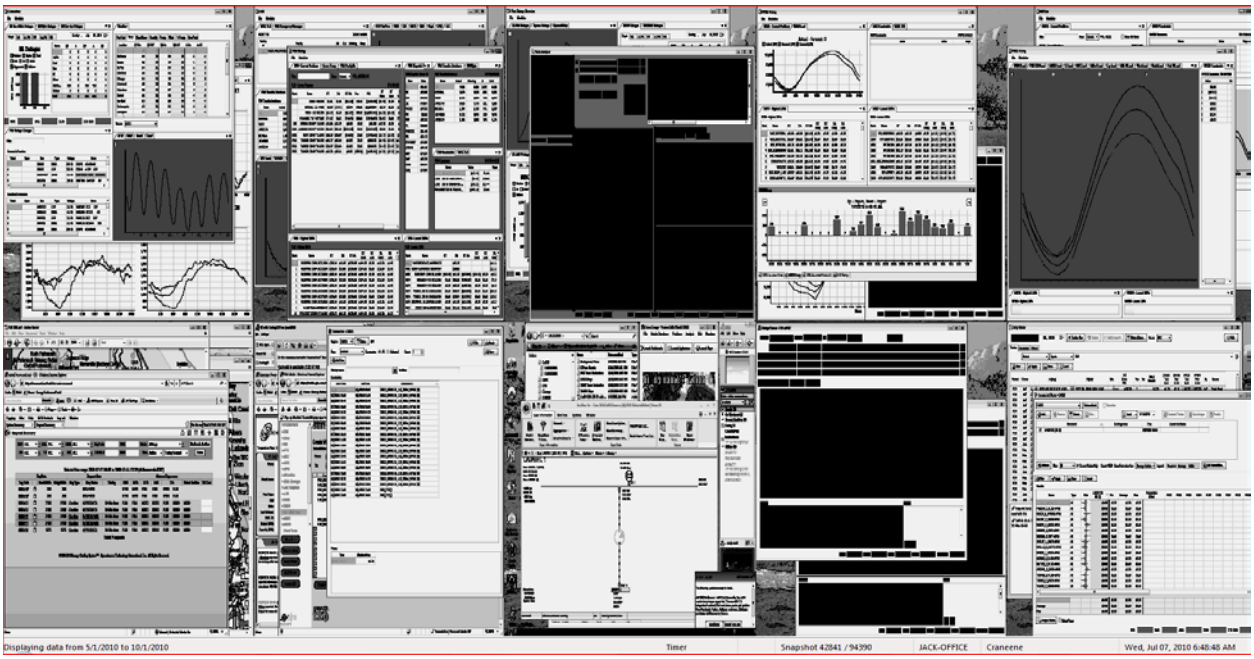
# APPENDIX A to Enforcement Staff Reply to Respondents' Answers to Order to Show Cause, Docket No. IN16-4-000

**Screenshot 1**: This is the last screenshot from Wells's office monitors on Tuesday, July 6, 2010, and shows that he left a number of applications running before the monitors turned off:[1]

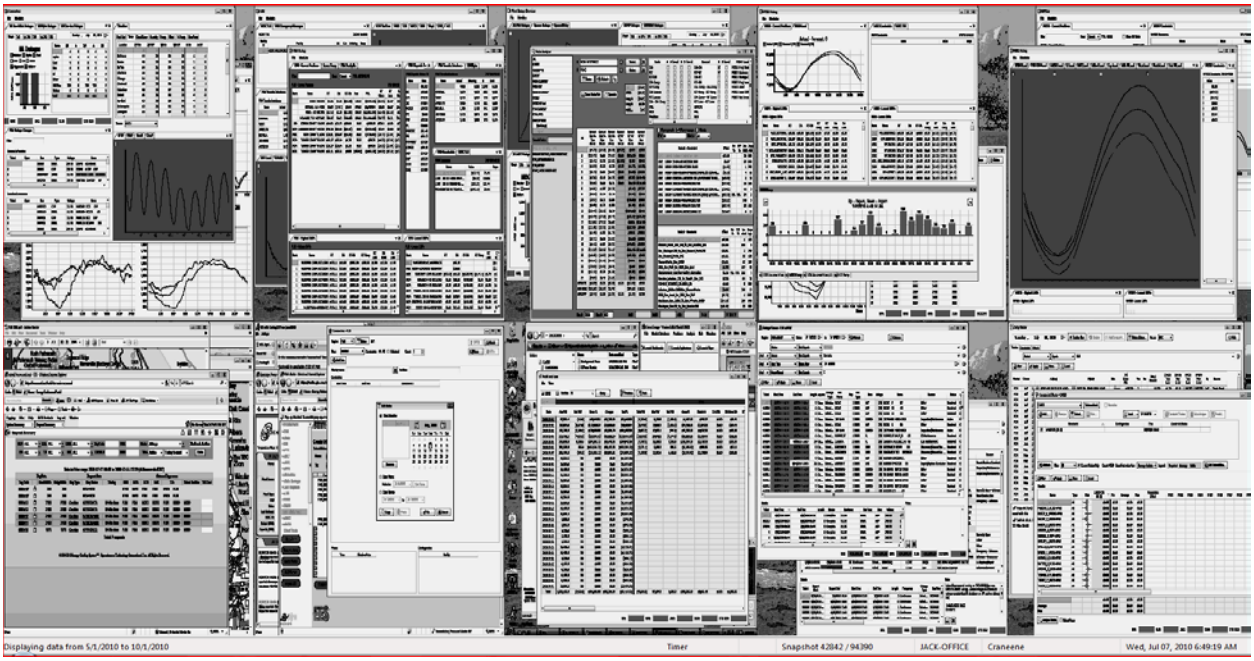



**Screenshot 2**: The next morning, Wells "woke" his office monitors at 6:48:48 a.m. (this screenshot depicts some of the applications still "waking up"):[2]

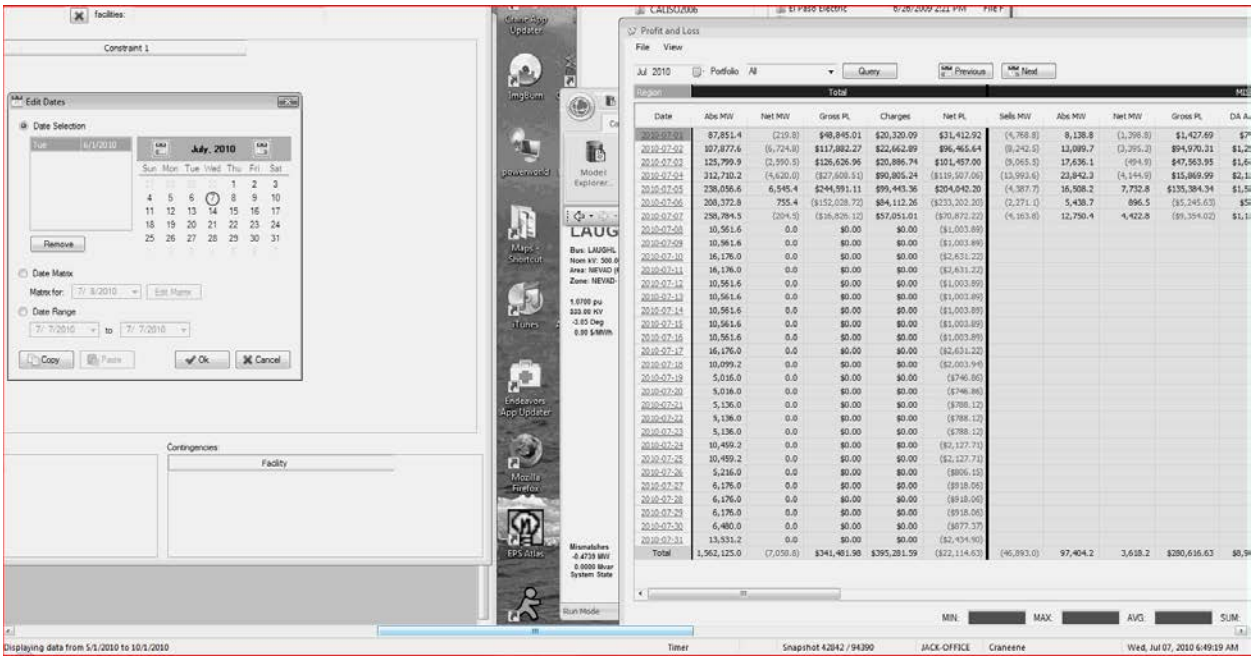



[1] Wells Screenshot 42777, July 6, 2010 3:26:36 p m. (unexcerpted).
[2] Wells Screenshot 42841, July 7, 2010, 6:48:48 a m. (unexcerpted).

**Screenshot 3**: About thirty seconds later, Wells opened the company's P&L application and the constraint viewer (bottom middle):[3]

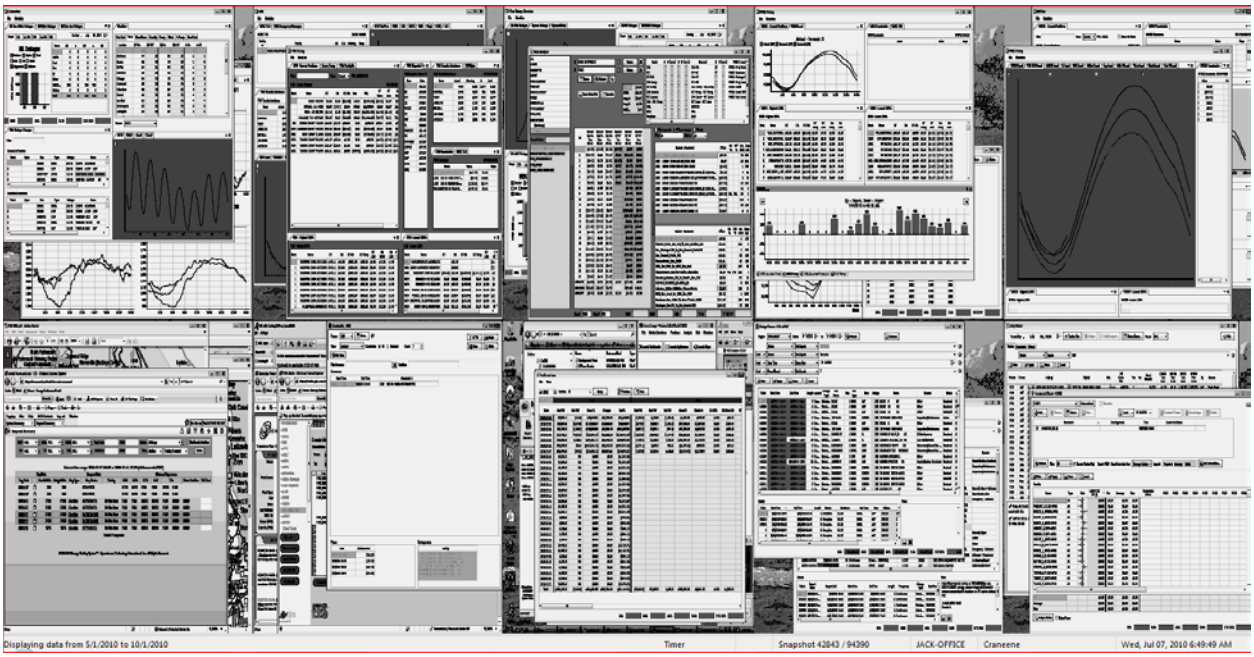


**Screenshot 4**: This is a magnified view (of Screenshot 3) that shows the application windows that he opened that morning:[4]

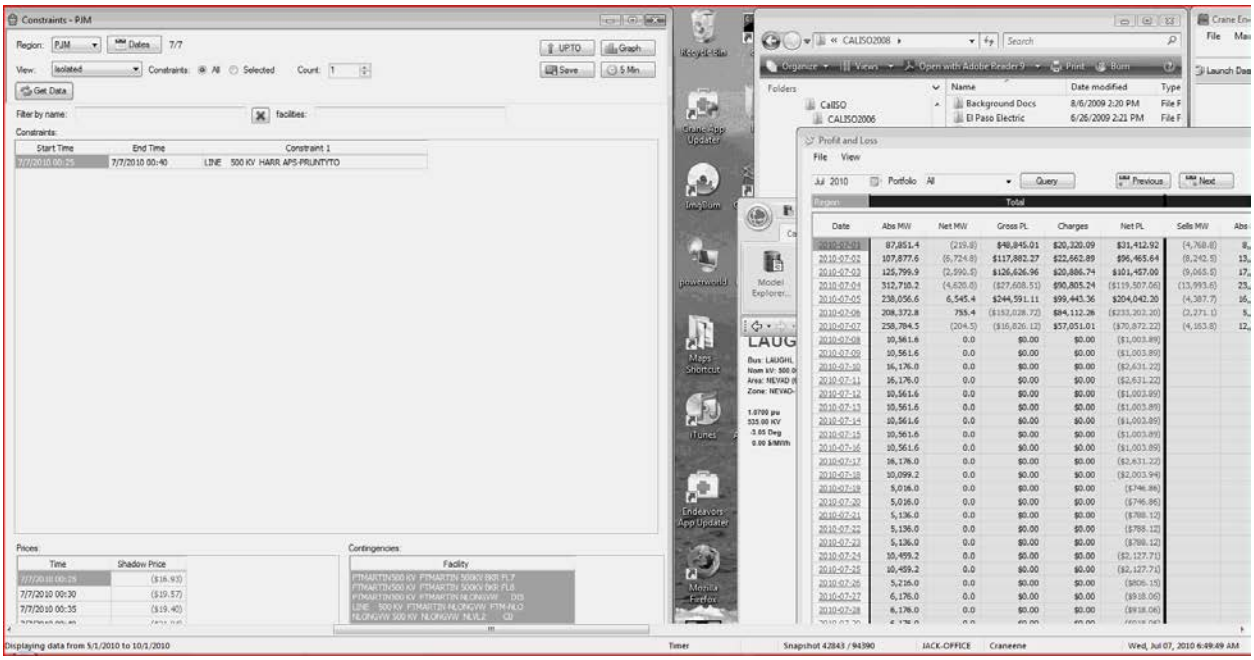


[3] Wells Screenshot 42842, July 7, 2010, 6:49:18 a m. (unexcerpted).
[4] *Id*. (excerpt).

**Screenshot 5:** The next screenshot (about thirty seconds later) shows the constraint viewer open (bottom middle):[5]

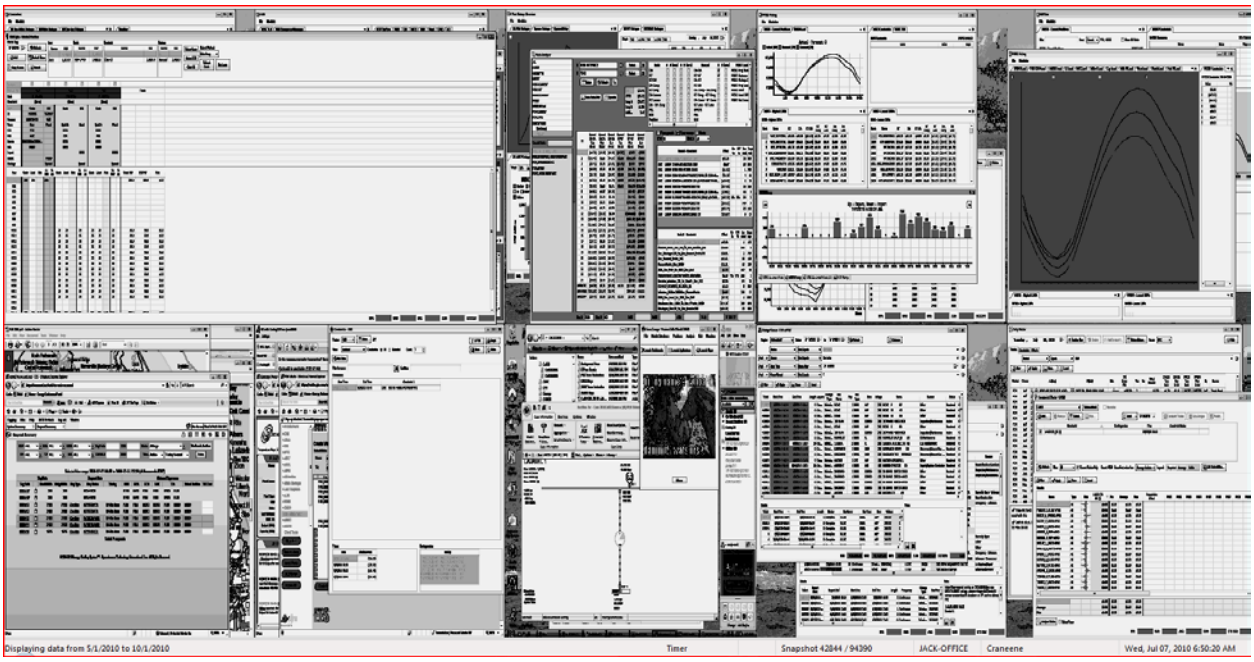



**Screenshot 6:** This is a magnification of that same screenshot, showing the only constraint analysis that he could see:[6]

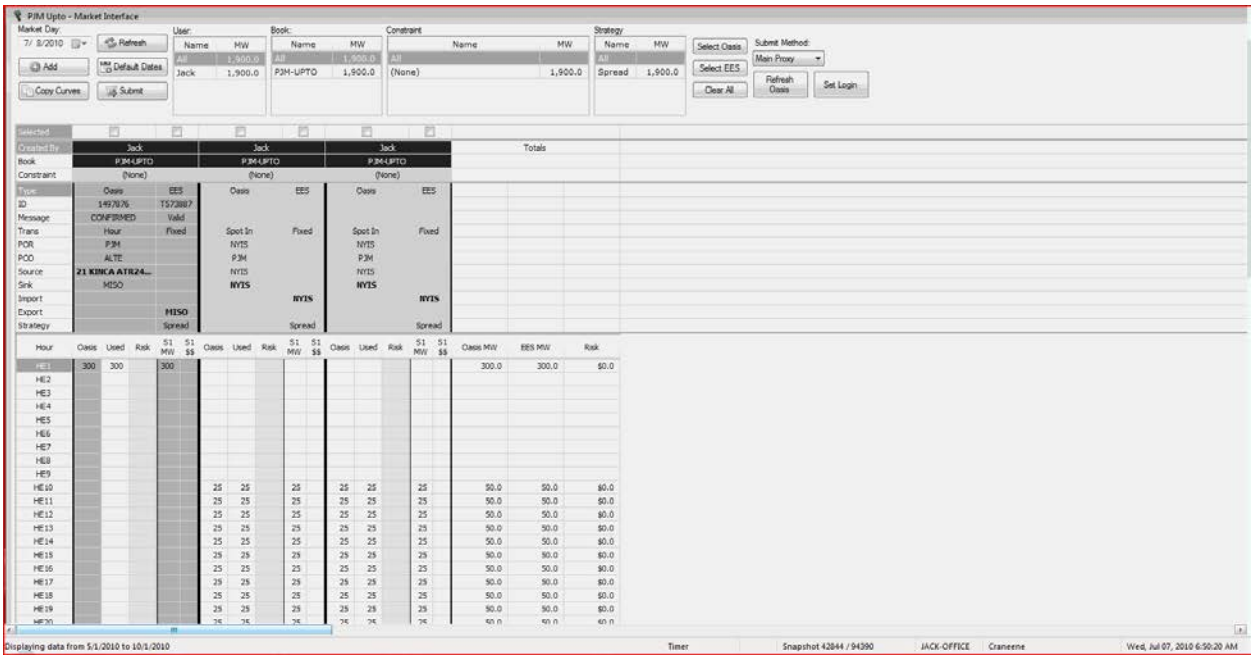



[5] Wells Screenshot 42843, July 7, 2010, 6:49:49 a m. (unexcerpted).
[6] *Id*. (excerpt).

**Screenshot 7:** Thirty seconds later (at 6:50 a.m.), Wells opens the "Market Interface" application (upper left), with a small volume of spread trades already entered:[7]

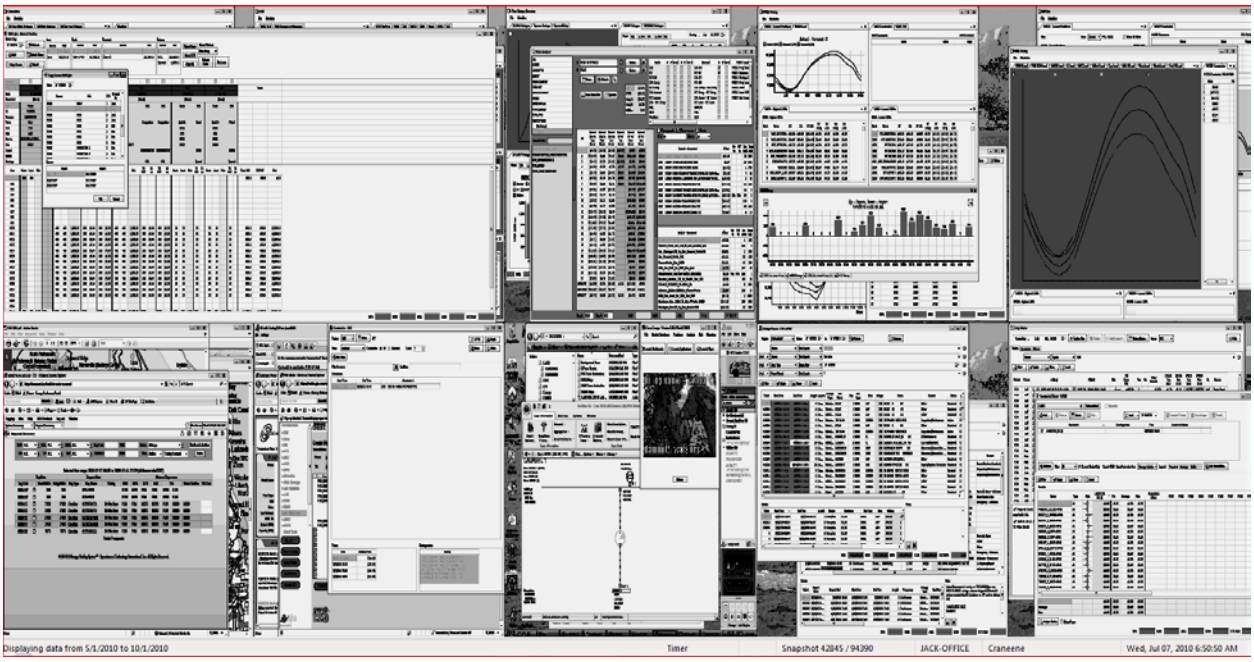


**Screenshot 8:** This is a magnified view of the Market Interface from the same screenshot, before Wells had begun to schedule OCL trades in Coaltrain's internal systems:[8]

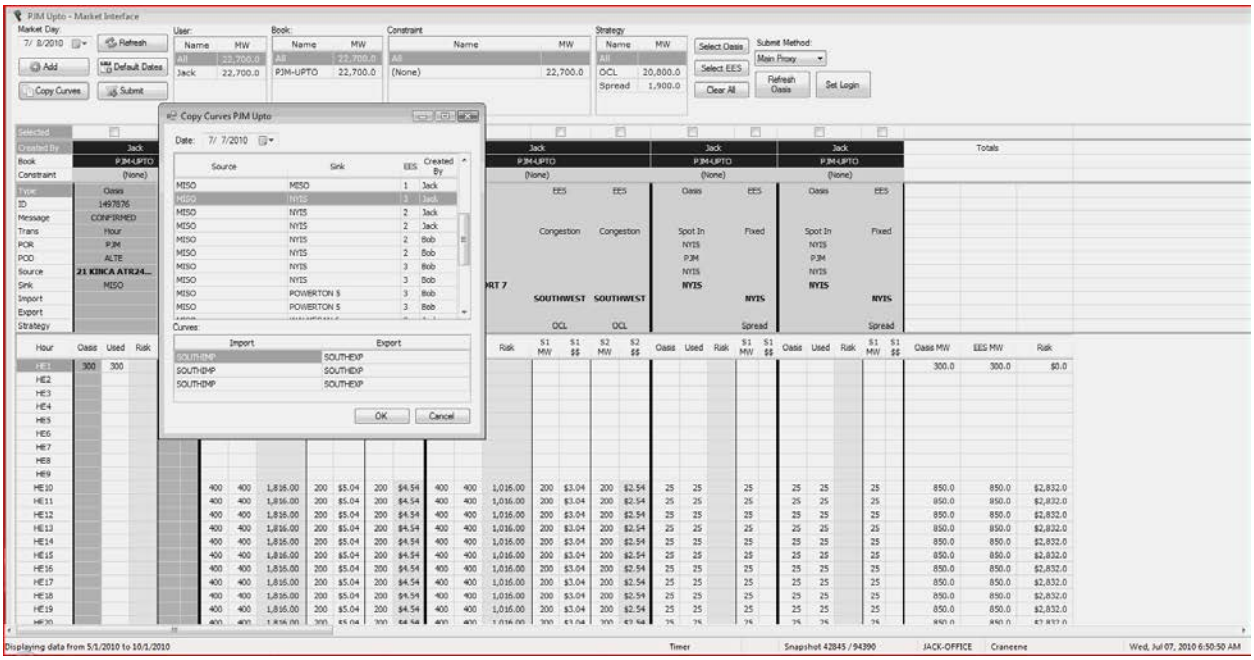


[7] Wells Screenshot 42844, July 7, 2010, 6:50:20 a m. (unexcerpted).
[8] *Id.* (excerpt).

**Screenshot 9:** In the very next screenshot (at 6:50:50 a.m.), Wells begins entering his daily OCL trades into the Market Interface:[9]

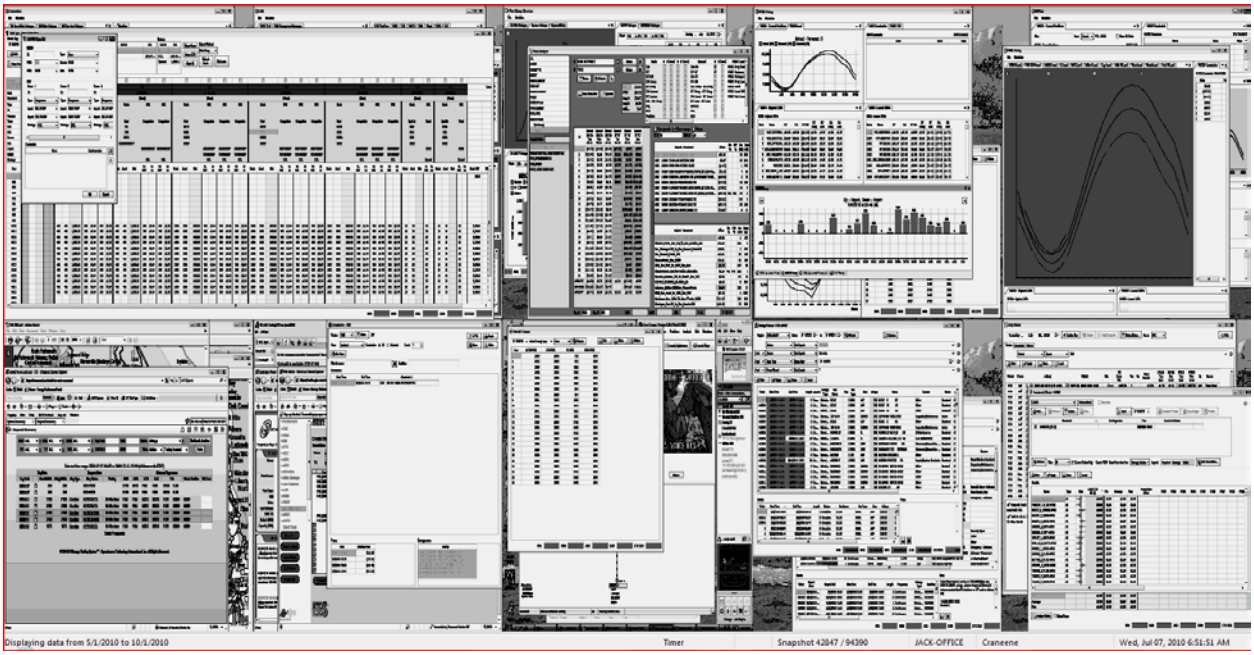


**Screenshot 10:** This magnification of the same screenshot shows Wells scheduling 20,800 MWh of SouthImp-Exp trades in Coaltrain's internal systems:[10]

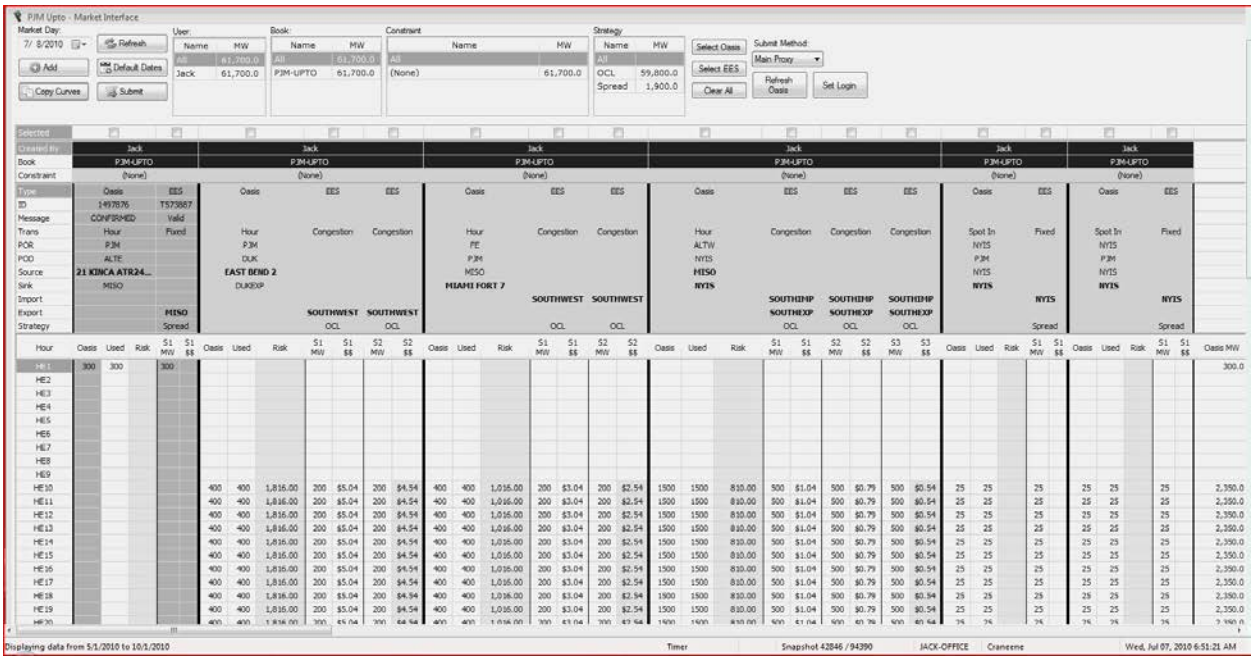


[9] Wells Screenshot 42845, July 7, 2010, 6:50:50 a m. (unexcerpted).
[10] *Id.* (excerpt).

**Screenshot 11:** And about thirty seconds after that, Wells enters even more OCL trades into the Market Interface (upper left) while looking at the company's "PJM ATC Viewer" application (bottom middle):[11]

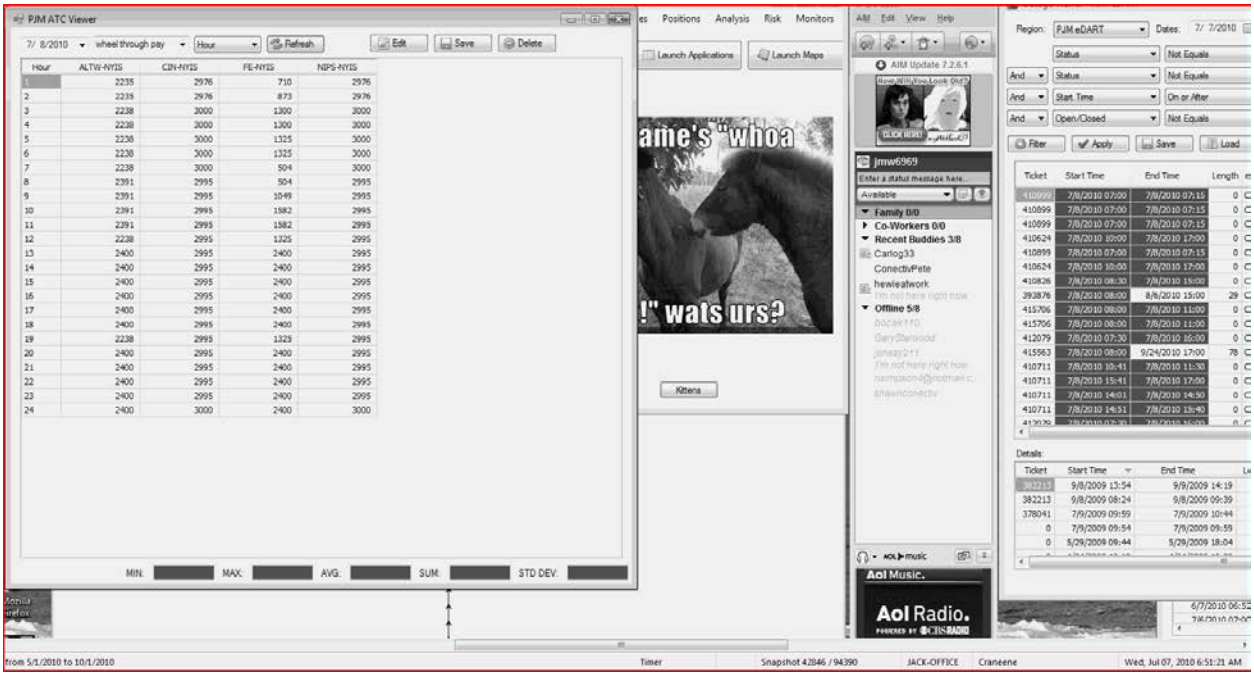


**Screenshot 12:** The magnification of the Market Interface shows Wells's OCL volume is now nearly 60,000 MWh:[12]

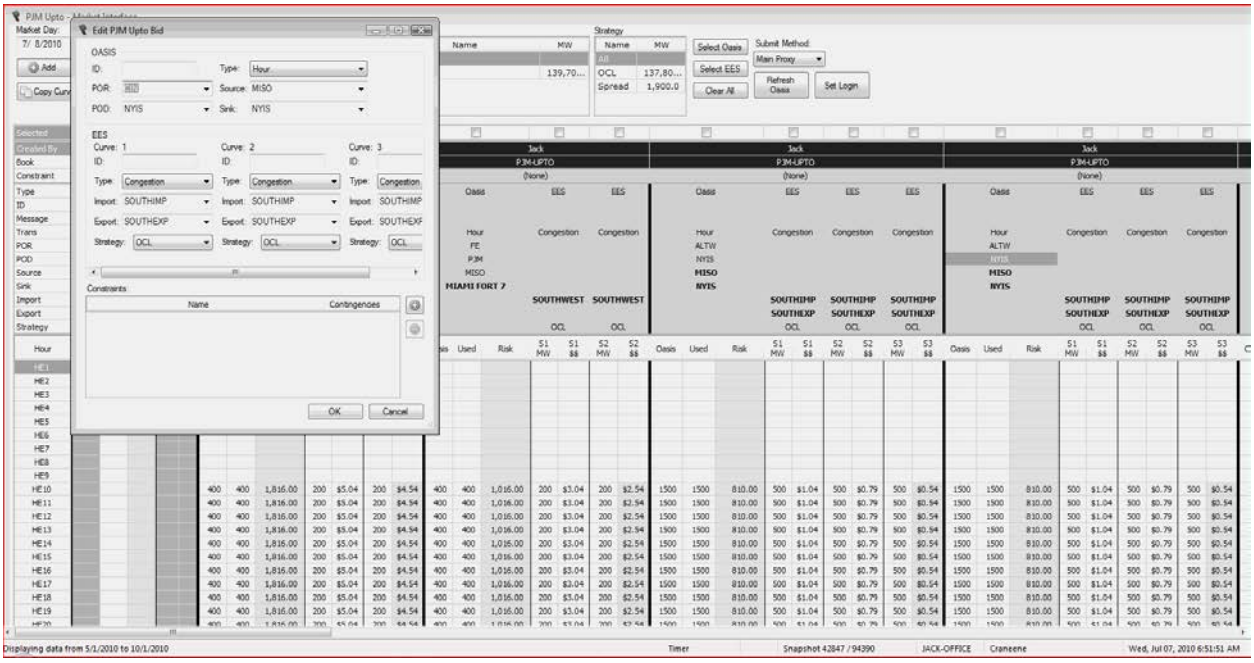


[11] Wells Screenshot 42846, July 7, 2010, 6:51:21 a.m. (unexcerpted).
[12] *Id.* (excerpt).

**Screenshot 13:** Magnifying a different part of the same screenshot, Coaltrain's PJM ATC Viewer application shows that Wells was reviewing how much transmission was available:[13]

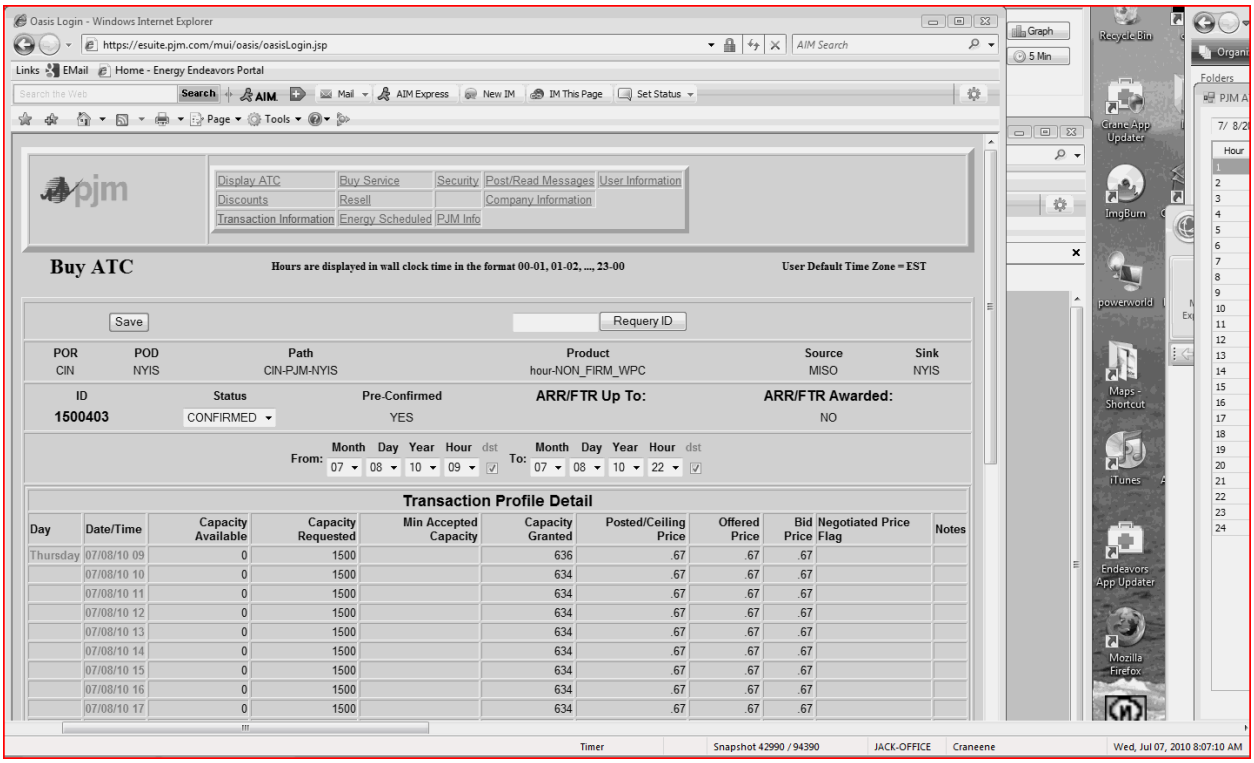



**Screenshot 14:** About thirty seconds later (at 6:51:51), Wells has placed 137,800 MWh of OCL trades into the Market Interface, just 3 minutes after his monitors turned on:[14]




[13] *Id.* (excerpt).
[14] Wells Screenshot 42847, July 7, 2010 6:51:51 a m.

Wells Screenshot No. 42990 (Jul. 7, 2010 8:07:10 a.m.)



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