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On the Subject

Energy & Commodities Advisory

September 20, 2010

The Federal Energy Regulatory Commission recently issued revised penalty guidelines based, in part, on industry comments calling for certain changes, such as partial compliance credits, and added a mandatory scienter requirement to assess penalties for misrepresentations or false statements.

FERC Reissues Penalty Guidelines and Introduces Scienter Requirement for False Statements

On Friday, September 17, 2010, the Federal Energy Regulatory Commission (FERC) issued its Revised Policy Statement on Penalty Guidelines, following a round of industry comment on the original penalty guidelines issued March 18, 2010. (For a complete description of the original guidelines, see "Grab Your Calculator: FERC Unveils Complex Scheme to Determine Penalties.") at http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/7266405d-ec13-4011-89c5-903533215e2f.cfm

The original penalty guidelines—which FERC issued without an opportunity for industry comment—were a substantial departure from the case-by-case approach that FERC employed. Instead, FERC developed a defined calculation scheme involving a five-step analysis, which was modeled after the U.S. Sentencing Guidelines. The original penalty guidelines nonetheless allowed FERC to depart from the calculation scheme if circumstances warranted. FERC Enforcement staff then conducted a series of workshops to explain how the guidelines functioned and to answer questions. However, based on the feedback staff received during the workshops, FERC issued an order in mid-April suspending the guidelines, and granted the public an opportunity to submit comments on the guidelines.

On September 17 FERC re-issued the penalty guidelines in modified form. They are largely unchanged and still follow the U.S. Sentencing Guidelines; however, in response to industry comments, FERC agreed to make a number of changes to them, including:

- **Partial compliance credit**—the original guidelines granted compliance credit to organizations that committed a violation despite having a compliance program only if the compliance program satisfied all of the elements in a series of specific criteria (listed below). The revised rules now offer the possibility of receiving partial compliance credit for cases in which a company's program satisfies many, but not all, of the compliance criteria established by FERC.
- **Senior-level involvement**—the original guidelines automatically denied compliance credit in cases where an entity's senior-level personnel were involved in the conduct, either through their participation, approval or mere acquiescence. FERC has abandoned this per se approach in the revised guidelines in favor of a case-by-case analysis. FERC envisions circumstances where senior-level employee involvement should not automatically deny a company compliance credit.
- **Organization size as a factor for granting compliance credit**—the original guidelines suggested that FERC would consider an organization's size when determining whether to grant compliance credit. In response to calls for a precise definition for "small" and "large" organizations, FERC developed a list of factors it would consider when determining an organization's size, including: (i) the number of employees; (ii) annual revenue, profits and budget; (iii) the number of separate operating divisions or units within the organization; (iv) the number of senior-level employees; and (v) the corporate structure of the organization.
- **Independent credit for self-reporting, cooperation, avoidance of a trial-type hearing and acceptance of responsibility**—the original guidelines provided bundled credit for circumstances where a company satisfied all of these factors. However, FERC has modified this credit by unbundling each item so that companies can receive independent credit for satisfying each of these factors.

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- **Reliability violations**—the revised guidelines reflect a number of important changes to the application of the penalty guidelines to reliability violations. FERC agreed to reduce the base-violation level for reliability violations, with a corresponding increase in the enhancements for harm resulting from such violations. Additionally, FERC will not be required to calculate load losses resulting from reliability violations, citing the potential difficulty of calculating the value of such losses associated with reliability events.

Significantly, FERC made a major adjustment to how it will approach cases involving misrepresentations or false statements to the commission. The penalty guidelines provide a separate base-violation level for such cases. However, concerned about the possibility of misunderstandings and inadvertent omissions, FERC has raised the threshold for its Enforcement staff by adding a scienter requirement that must be established in order for a company to be assessed penalties for such misrepresentations or false statements. FERC will now require staff to demonstrate that companies that allegedly have made misrepresentations or false statements did so intentionally or recklessly.

As noted above, FERC will now give partial credit for compliance programs that satisfy some, but not all of the elements listed in its penalty guidelines. These compliance elements include:

- Exercising due diligence to prevent and detect violations
- Promoting a culture that encourages a commitment to compliance
- Developing standards and procedures to prevent and detect violations
- Ensuring the organization's governing body is knowledgeable about the content and operation of the compliance program and exercises oversight with respect to the program's implementation and effectiveness
- Ensuring senior management makes certain the organization has an effective compliance program, and specific members of senior management are assigned overall responsibility for it
- Delegating specific personnel to have day-to-day operational responsibility for the program and to report periodically to senior management and the governing body, as appropriate, on the effectiveness of the program (such personnel shall be given adequate resources and authority to carry out these duties, including appropriate access to the governing authority)
- Using reasonable efforts to exclude from the "substantial authority personnel" persons who have engaged in violations or conduct incompatible with an effective compliance program
- Communicating compliance standards and other aspects of the compliance program via training programs and other mechanisms
- Taking steps (such as monitoring and audits) to ensure the compliance program is being followed
- Undertaking a periodic performance review of the compliance program
- Instituting a hotline or other anonymous/confidential reporting system for reporting potential compliance concerns and questions
- Promoting the compliance program through an appropriate combination of incentives and disciplinary measures, both of which must be enforced consistently
- Responding quickly to the detection of violations and making changes necessary to prevent their recurrence
- Periodically assessing the risk of violations and taking steps to adapt the compliance program to address such risks

The McDermott Difference

McDermott Will & Emery's lawyers have assisted numerous energy companies and financial institutions with the development and implementation of compliance programs designed to address the requirements of FERC and the U.S. Commodity Futures Trading Commission. We are available to assist companies as they evaluate whether their programs meet the above requirements of FERC.

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