Are regulators capable of separating legitimate from manipulative REMIT and MAR behavior?

Regulators will have the daunting task to separate a legitimate trading strategy from a manipulative one. Due to a limited knowledge about the trading activates executed by the traders among the regulators, I fear that they will play it safe; i.e. start investigations into any suspected price manipulation attempt.

Although from the regulator's perspective understandable, I would like to stress that they should be careful in pursuing enforcement actions. From my advisory practice, I know that market players' uncertainty regarding the precise threshold for manipulation and fear of fines may lead them to behave with excessive caution in executing certain trading strategies. This will lead to reduced price discovery and market efficiency. Exactly the opposite of what is intended to be achieved by the REMIT and MAR regulations.

Potential danger areas for traders are the orderly execution of transactions during the opening and closing period, e.g., " marking or banging the close and "spoofing, i.e. bidding or offering with the intent to cancel the bid or offer before execution.

(Statistical) arbitrage is the lifeblood of energy traders; with intelligence coming out of their models they want to benefit from price disparities between different contracts with different tenors. Like benefiting from the undervaluation of a calendar year contract in comparison to the total value of the 4 quarterly contracts that make up that calendar year or they want to arbitrage away the price differentials between the Intraday and Day Ahead Market prices or Day Ahead and week contract prices.

Statistical arbitrage is a legitimate trading strategy, but what if this for instance happens at the close of the market. Imagine the following case, with 2 possible outcomes:

A trader with models suggesting that a certain contract is substantially undervalued might rationally place large numbers of orders. However, if such trading behavior occurs during the closing period, it may resemble 'marking or banging' the close. If the trader stops buying in the close, and the price falls substantially after they stop buying, the regulator might suspect this to be an attempt to manipulate the closing price and set this at an artificial level.

But what if the reality is that the price plateaus after the trader stops buying. This would suggest that the trader may have identified and corrected a legitimate underpricing relative to actual supply and demand in the market.

In other words the trader was potentially influencing the price with his trades, but did not create an artificial price. Is that a price manipulation attempt?

So traders are facing the risk that the regulator will pursue enforcement actions although they are actually engaging in legitimate trading strategies that, due to circumstances, may be difficult to distinguish from manipulative behavior.

Regulators need to have their monitoring system in order to ensure that they could separate the ‘good' from the 'bad' behavior. One way to achieve this is to educate the regulators' staff about the trading practices and psyches of the traders. That should not be done like I have sometimes noticed by talking to these same traders, but get it from independent expert sources like me to avoid that they are marking their own paper.

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