



## Energy Compliance Intelligence Series



# Regulation and Trading Compliance for Energy Trading **Your Monthly Update**

Issue 2, October 2016

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## From the editor



Thanks for all the nice words we received on our first issue of the Energy Trading Compliance Bulletin.

Also in this second issue we will give you the latest regulatory developments, best practices and practical questions from the trading floor.

Regulatory and Trading Compliance will be continuous work in progress and we hope to make your job somewhat easier.

Good business!

Amsterdam, October 2016

**Kasper Walet**

Managing Director, Maycroft

Email: [walet@macycroft.com](mailto:walet@macycroft.com)  
Tel: +3165381819



## ***Lessons Compliance Best Practices***

*The more comfortable regulators will be with the adequacy of your compliance program and the role of the compliance professionals, the less likely they will be willing to take enforcement actions against you. To give you the necessary tools for implementing an adequate compliance program, in each edition we will deal with a Compliance Best Practice.*

### **Market Abuse Systems and Controls**

According to a recent survey by the FCA there are many possible shortcomings in the compliance programs with regards to the market abuse systems and controls implemented by companies. Below we will describe the best practices.

#### **Market abuse risk awareness**

Market abuse should be a key risk for all firms and clearly the ability to identify these risks is very important in ensuring the most effective and robust systems and controls are in place.

For the flows of confidential and inside information it is important that employees at all levels understand their role in controlling these flows of information and making this an integral part of how they carry out their work. In addition, business heads acting in a supervisory capacity should take responsibility for controlling flows of information, with appropriate challenge and monitoring from the second and third lines of defense.

Regular risk assessments are very important in mitigating the risks of market abuse. The best practice is that firms conduct detailed assessments of market abuse risks that includes a comprehensive list of the relevant risks and the key responsibilities for managing and mitigating these risks, including the controls employed to achieve these goals.

Firms who are not conducting regular market risk assessments will face difficulty in demonstrating to the regulators that effective controls are in place.

## **Information barriers**

Maintenance of effective information barriers will be essential to mitigate the risks of market abuse including insider dealing and the unlawful disclosure of inside information. This is particularly important where firms have multiple information barriers in place, which may not always be separated by physical barriers.

An example of a situation in which a conflict of interest could arise is where senior management, often classified as Permanent Insiders, are situated (or have an additional desk) within close proximity to the trading desks, and have access to traders' trading book positions.

In order for information barriers to operate effectively they need to be clearly defined and understood. That could be achieved by having physically segregated individuals or teams that regularly have access to confidential or inside information.

However, where this is not possible, firms might consider taking extra steps to ensure the information barriers are properly managed and maintained. This could include specific training for staff operating in these areas and ensuring Compliance representatives are properly integrated with front office operations to improve manual surveillance capabilities and information management.

## **Wall-crossing procedures and Insider lists**

"Wall crossing" is the act of making a person an "insider" by providing them with inside information. The level of documented wall-crossing procedures should be good. This includes procedural and record-keeping provisions in relation to both wall-crossed and non-wall-crossed market soundings.

The most effective approach seems to be as the Compliance team acts as 'gatekeepers' in all wall-crossings. In these circumstances the Compliance team would judge whether the wall-crossing was necessary, who was the correct person to wall-cross and finally the most appropriate time to do this. It would allow firms to centralize the wall-crossing process, reduces the risks of inadvertent wall-crossing, and provides a more consistent approach.

Insider lists need to be accurately documented and suitably detailed.

It is important that firms consider the ‘need to know principle’ when determining which individuals need to be wall-crossed on a transaction and consequently included on an insider list. This principle helps firms and individuals in ensuring that inside information is only disclosed where it is in the ‘normal exercise of an employment, a profession or duties’.

Inside information disclosed otherwise constitutes unlawful disclosure and is prohibited. It is important to always keep the number of people privy to inside information to the minimum necessary to perform a particular role or task to the appropriate standard.

### **Market abuse monitoring and surveillance**

Post-trade monitoring and surveillance has a key role to play in both detecting and deterring market abuse. This includes requirements for firms to have effective arrangements, systems and procedures to detect and report suspicious orders and transactions. A best monitoring practice would be where firms periodically monitor the trading activity of traders during periods when individuals at the firm had been wall-crossed. This type of extra due diligence could be considered by the regulator as an important step in mitigating the risks of market abuse.

Regarding the level of sophistication of post-trade surveillance tools firms need to be particularly careful when selecting suitable surveillance tools and setting alert parameters. The most effective surveillance programs involve significant and careful calibration of both the alert parameters and alert logic based on the surveillance officers’ experience of that firm’s trading patterns.



## News from the Regulators

*It will cost you a lot of time tracking and analyzing regulatory change and interpretations by the regulator. To support you with this time consuming task, in each edition we will deal with the latest changes and violation cases by regulators.*

### **REMIT and MAR**

With regards to REMIT and MAR there were no new developments during the previous month.

### **MIFID II and energy and commodity traders**

What energy traders would like to know is whether they need to be licensed under MiFID II yes or no? There is news about the tests whether you will be in or out.

#### **MiFID II in/out tests for energy traders expected at beginning Q4**

The European Commission said it expects to adopt soon the tests that traders will have to pass in order to avoid being captured by stringent EU financial regulation. The tests under consideration are a market size test, a main business test and a capital-based test for companies with large investments in infrastructure such as power plants, so their trading activity would be measured against their overall assets.

“RTS [regulated technical standards] is expected to be adopted at the beginning of the fourth quarter,” according to a commission official.

The tests will determine if energy and commodity traders need to be licensed under the second markets in financial instruments directive (MiFID II). Commodity traders can avoid falling under the directive if they can prove their trading activity is ancillary to their main business.

Market participants are keen to get clarity as soon as possible on the tests, so they can start calculations for determining whether they are likely or not to be captured by the directive.

Energy traders operating under MiFID II, which will apply as of January 2018, would need increased capital reserves what would ultimately lead to an increase in costs to trade.

# Investigations



There were no new REMIT or MAR investigations being published in the previous month. However, due to the lack of REMIT cases there are valuable lessons to be learned from the financial industry and other jurisdictions. This month we take a look at 3 relevant cases by the US commodity trading regulator, CFTC.

## Spoofing

On the subject of spoofing, looks like the CME has a hot one on its hands. Cross market manipulation, money laundering, the whole deal. In a notice, CME said that Andrey Sakharov has been denied access to all of its markets, and it prohibited trades and the placing of orders from any accounts he owns or controls for 60 days while the investigation is ongoing.

*First a few words on what spoofing is. It is an illegal type of market manipulation that works like bluffing: A trader places big orders for instance for electricity futures to get others to think the price is going up or down. Then, in the blink of an eye, the spoofer cancels those orders and puts in opposite orders to take advantage of those traders. Spoofing can earn a big payoff but can undermine confidence in the markets and hurt other traders.*

*Some firms have developed software to red-flag suspected spoofing to avoid getting duped. One problem traders and their lawyers are worried about is whether legitimate market activity could get swept up in anti-spoofing rules. Since time immemorial, traders have used techniques to hide their intentions. For instance, a trader on behalf of a company that needs electricity could theoretically start out by saying he wants to sell rather than buy to avoid other traders catching on to his plan.*

In this particular case the CME says that, "Sakharov, while trading an account held in another's name, and without an executed power of attorney, repeatedly placed single orders for small quantities on one side of the August 2016 gold and natural gas futures markets, followed by single orders for large quantities on the opposite side of these markets. Generally, less than 100 milliseconds thereafter, the small-quantity orders traded and the large-quantity orders were canceled.

The investigation also found that Sakharov entered many trades at multiple other accounts held in other people's names. CME said Sakharov "informed the firm that introduced these accounts to the clearing member firm that while he wanted to have individual access to these accounts, as well as future accounts he planned on opening with the firm, he did not want to be officially associated with the accounts since he was concerned that he may be banned from trading following this investigation."

CME also said the introducing firm told investigators that the account where Sakharov performed his gold and natural gas futures trades has been reported to the Cyprus Securities and Exchange Commission for alleged money laundering as well.

### **Reporting violations and related supervision failures**

CFTC charged Deutsche Bank as its swap data reporting system experienced a systems outage that prevented Deutsche Bank from reporting any swap data for multiple asset classes for approximately five days. Deutsche Bank's subsequent efforts to end the System Outage repeatedly exacerbated existing reporting problems and often led to the discovery or creation of new reporting problems, many of which violate a CFTC Order.

For example, the Complaint alleges that Deutsche Bank's swap data reported before and after the System Outage revealed persistent problems with the integrity of certain data fields, including numerous invalid legal entity identifiers (LEIs). The Complaint further alleges that a number of these reporting problems persist today, affecting market data that is made available to the public, as well as data that is used by the CFTC to evaluate systemic risk throughout the swaps markets.

The Complaint also alleges that the System Outage and the subsequent reporting problems transpired at least in part because Deutsche Bank failed to have an adequate Business Continuity and Disaster Recovery Plan and other appropriate supervisory systems in place.

## **Artificial prices**

*Enron is long gone, but the underlying case is still relevant to the compliance of European energy trading firms.*

CFTC looked at the trading behavior of Enron and one of its traders, Hunter S. Shively, and discovered that Shively had purchased an extraordinarily large amount of Henry Hub spot natural gas contracts in a period of 15 minutes, causing an artificial price rise.

This unusual trading behavior, combined with Shively's offer to cover the losses of another trader and evidence he communicated his intent to "bid-up" the market, helped CFTC demonstrate the intent to create artificiality, and the resulting price increase demonstrated the creation of actual artificiality.

Immediately after buying the natural gas contracts, Enron began to sell its accumulated Henry Hub spot natural gas contracts. They profited from the price artificiality it created earlier, demonstrating Enron's motive and further evidencing its intent.

The CFTC ultimately collected a \$35 million civil monetary penalty from Enron in the settlement of its enforcement action.



## Questions from the Trading Floor

*Despite the Guidance's and Q&As to overcome the lack of clarity and uncertainty surrounding REMIT and MAR, in practice there still are many trading issues of which it is still not clear whether these would be considered a suspicious trade or order by the regulator. To prevent market abuse, your company is expected to proactively analyze your trading activities on a daily basis and diagnose whether there are possible violations. To support you with this task we will deal with 2 cases coming directly from the trading floor in each edition.*

### **Case: Front running yes or no?**

Trader James is contacted by Trader Marcel of a counterparty. Marcel tells James that he has a buying interest for 14 MW of Day Ahead. James gives Marcel an offer, however Marcel declines.

James now buys 90MW in the market, based on the expectation to resell it later. James at least knows that Marcel is in the market for 12MW.

#### Question 1

Is James front running?

#### What the experts say:

This usually is not considered front running as James is trading based on common trading information exchange and it certainly is not insider information. It is common trading practice that by talking to different possible counterparts and brokers in the market you collect your trading intelligence that help you to structure a trading strategy. Marcel will most likely talk to several other traders and brokers to get the lowest offer. Besides James is exposed to the full price risk.

It would have been different if James would have to execute the deal for Marcel and based on that information first take an advantageous position himself before executing Marcel' s order, that would be front running

## Question 2

Now assume that James offers Marcel a price of € 16,75 and that Marcel accepts this offer. Back -to back James is buying the 14 MW on the exchange for a price € 0,25 lower. Would this be allowed?

### What the experts say

Yes, no doubt about it as this is common trading practice.

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