Energy Compliance Intelligence Series

Regulation and Trading Compliance for Energy Firms

Your Monthly Update

Issue 4, December 2016

Table of Contents December issue

From the editor 3
News from the regulators 4
- MiFID II; Good news to energy companies
- Possible relaxation of EMIR for energy trading firms 6

Investigations 7
- Spoofing Allegations; Project Damson
- Germany: 13 REMIT breaches under investigation 8

Trade Surveillance 10
- The Surveillance Gap; Most firms not 100% REMIT and MAR compliant yet

Questions from the Trading Floor 13
Case: Is statistical arbitrage market manipulation?
Order Form 15

From the editor

In the continuous saga about whether energy and commodity trading companies will be caught by MiFID II yes or no, there is some good news. The European Commission has just released a proposal that could lead for several energy companies that they will be out for MiFID II.

This is the final issue that will be send out on a complimentary basis. So if you would like to receive the bulletin also 2017, all you have to do is fill in the order form included at the end. For less than € 50 a month you will be updated on the latest developments and insights, that could help you save 10 or even hundred thousands of Euros in costs or fines. I would say that would make for an investment well spend.

I would like to wish you all a Merry Christmas and a Happy New Year!

Amsterdam, December 2016

Kasper Walet

Managing Director, Maycroft

Email: walet@maycroft.com
Tel: +3165381819

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.

MiFID II; Good news to energy companies

Commission releases revised in/out tests

There is good news for power and gas traders as the European Commission finally published its rules on how traders can remain outside of the onerous MIFID II financial regulation.

*The "**Ancillary Activity Exemption**" from MiFID II will most certainly be the central point of interest for firms involved in commodity and carbon trading in the following years. Part of this exemption is the so-called "market share" test (that assess whether a company's speculative trading is high in relation to overall trading) the commission proposes to take into account the capital used by non-financial firms in their physical activity. Through this proposal European utilities as well as other energy traders can include their investments in assets when measuring their trading activity against group activity. This will take away their fears that the tests would capture a lot of smaller companies and that the increased requirements to clear trades and maintain capital reserves would increase retail prices, while reducing wholesale market liquidity.*

Energy traders will now be able to include capital invested in physical assets and other areas when determining if they will need to operate under the new MiFID II financial rules from 2018. According to the EC proposal energy traders can now include investment in plants and equipment, total equity and other measures of financing in the capital calculation. This calculation will be a complicated, time-consuming and costly exercise. Although for most companies it is preferable to operating under MiFID.
However as a disclaimer; the rules still need to be approved by the European Parliament and Council. Listening to some reactions made by key stakeholders it is quite likely that the rules will take this hurdle.

Companies now have to pass two tests to avoid being regulated as a bank

1. A market size test, in which a company's position in an asset class such as gas or power derivatives must be under a certain threshold (see the table below for the threshold details). This is assessed over a three-year rolling period backdated to 2015.

Market size test	
Commodity derivatives	**Threshold**
Oil and oil products	3%
Gas	3%
Metals	4%
Agricultural products	4%
Power	6%
Coal	10%
Other commodities, including freight	15%
Emissions allowances	20%

2. A test that judges trading activity against overall activity of the company, and is known as the main business test. The commission has now developed a simplified version of an approach used in the Capital Requirement Regulation (CRR). This "ancillary test" represents a ratio between:
   (i) The capital that would need to be allocated under CRR for the firm to engage in speculative derivatives trading versus
   (ii) The capital employed to conduct a firm's main business.

   Once firms calculate their capital employed using this method, their trading activity must account for less than 10% of that.

To be able to successfully execute this exercise it is important to understand what the criteria are for when an activity is considered to be ancillary to the main business and how to pass an overall market threshold test, a main business threshold test and a capital employed test.

Furthermore understand what the exact criteria for transactions qualifying as reducing risks are.

For energy market participants important as well is the definition of derivative financial instruments regarding indexed delivery contracts, which are used widespread in the energy sector. As it stands right now these are to be considered as financial instruments which consequently has an impact on the number and type of contracts that have to be considered for the Ancillary Activity Exemption.

With the process of responding to all these regulations will be both costly and time consuming and keep you busy in 2017.

Possible relaxation of EMIR for energy trading firms

The European Commission recently published a report, which provides views of the implementation of EMIR since it came into force in August 2012. Some of the interesting findings to energy traders as expressed in the report are that EMIR has been burdensome for many energy traders as NFCs. Most of these companies are of less relevance from a systemic perspective. Therefor the EC thinks that it would be appropriate to reduce the burden of EMIR for "smaller" NFCs. As the "large" NFCs should be caught by the "NFC+" rules, which amongst other things mandate mandatory clearing and the "uncleared margin rules", as well as more complex reporting requirements. The EC therefore shares the idea of ESMA of "simplifying" the calculation of the clearing threshold, by no longer permitting a hedge exemption, and at the same time raising the threshold.

This, combined with the possibility of more Financial Counterparties arising out of the just announced Ancillary Activity test under MiFID II (see ????), could see large and medium sized energy market participants face a greater burden from EMIR than the smaller companies.

Investigations

Below is a description of a spoofing case in the UK as well as an overview of the number of REMIT cases under investigation in the biggest trading market in Europe, Germany.

Spoofing Allegations; Project Damson

In a probe called “Project Damson”, the UK energy regulator Ofgem is investigating whether traders manipulated the price of energy contracts using a technique known as ‘spoofing’. The practice of spoofing typically consists of systematically placing orders without intending to execute them to trick the market into thinking there’s interest in buying or selling that doesn’t actually exist.

Authorities across markets have been clamping down on so-called spoofing since it was cited as a catalyst for the Flash Crash in U.S. equities in 2010.

In this case, Ofgem is examining allegations that traders in the UK pushed up the price of derivatives which track the 'spark spread' by posting and then cancelling orders in short succession, the documents show. The documents describe how one trader targeted by the investigation placed and then cancelled multiple buy orders to inflate the price of a contract for the summer of 2014 and increase the value of his trading portfolio.

The clean-spark spread measures the profitability of producing power from natural gas, taking into account carbon costs. Traders can buy or sell standardized contracts on the Intercontinental Exchange Inc.'s ICE Futures Europe market or as over-the-counter derivatives via brokers.

Ofgem investigators consulted the U.K.'s main financial regulator, the Financial Conduct Authority, in the early stages of the probe. However, the FCA seems to be no longer involved in the investigation.

Germany: 13 REMIT breaches under investigation

It is interesting to take a closer look at the REMIT investigations in the largest trading market in Europe; Germany. At the moment Germany's energy regulator Bundesnetzagentur (BNetzA) is investigating 13 potential breaches of REMIT rules on market manipulation. Eight of the cases are being probed together with other European regulators.

The cases concern, for example, trades possibly made with the aim of achieving an artificial price level, and suspected wash trades. Wash trading typically refers to two companies repeatedly exchanging the same contract at the same volume and price to give misleading signals about the supply-demand situation.

Between 2012 and early November this year, 19 possible breaches of REMIT were reported to BNetzA. In 2014 they received five reports of possible breaches of REMIT from other authorities. Two of these cases comprised a possible breach of the prohibition on insider trading and actually fall under the jurisdiction of foreign regulatory authorities. The three remaining cases related to a possible breach of the prohibition on market manipulation. Following a thorough examination, one of these cases was not pursued further. This case involved a suspected manipulation of wholesale gas products.

In 2015 the BNetzA received information about four suspicious cases. Three of the cases related to a possible breach of the prohibition on market manipulation and the other to an apparent unintentionally erroneous transaction. One of the breach issues is a suspected illegal blocking of cross-border transmission capacity with no intention of trading electricity, which BNetzA is currently investigating together with the other regulatory authorities affected. The case relating to the "manifest error" was dropped following a brief investigation.

BNetzA investigated seven cases in 2016. BNetzA has not imposed fines or filed criminal charges as a result of REMIT breaches so far.

Trade Surveillance

Being in compliance with the market abuse rules of REMIT and MAR regulations as well as maybe the upcoming MiFID II regulations (in force from January 2018) will require firms to implement from scratch or extend already existing market surveillance capabilities as well as capture market manipulation intent by reporting suspicious orders and suspicious transactions.

The Surveillance Gap

Most firms not 100% REMIT and MAR compliant yet

Empirical evidence from our own advisory practice shows that most power and gas traders are not 100% ready for the new set of rules under REMIT and MAR. Although most trading firms have some form of market surveillance in place, there is significant work outstanding to comply with REMIT and MAR due to the complexities of its surveillance.

The big question is whether you are fully confident that your systems will report all potential intent scenarios, or correctly mark electricity and gas - specific instruments such as hour-ahead electricity contracts without risking "marking the close" at the end of each hour?

Organizations trading in the European power and gas markets need to ensure that the full spectrum of market manipulation cases is covered for their specific ways of trading, covering detection of market abuse intent and cross-instrument alert scenarios. Automated market surveillance systems specifically designed to cover these markets could help fill the gaps, notably in the areas of alert logic, calibration and case management.

- **Alert logic:** Older surveillance systems fall short in applying the relevant alert logic needed for power and gas markets. Simply applying the equities trading alert logic to power and gas trading will not work, as all alert logic needs to be reviewed and transposed to the specific market structure and instrument types used in the energy markets. The different liquidity and correlation between the instruments needs to be considered as well.

- **Alert calibration**: It is a regulatory requirement for firms to rigorously review parameters for their alerts, and provide the rationale to regulators as to why these specific parameters have been selected, as well as the careful recording of any changes along the way in an immutable audit trail.

  A market surveillance system should enable you to specify a number of parameters for each alert instance, based on, for example, the timeframe of an evaluation window. Firms ultimately need to calibrate alerts based on their own specific business and instruments traded. For example, it could be considered useful to set up a parameter for a minimum profit on a spoofing alert in order to avoid pursuing alerts for profits of nominal amounts. Also alerts could be set up to provide reports focusing on specific traders so that a STOR can be submitted with confidence.

- **Case management:** Once alerts are correctly calibrated with false positives (noise) and false negatives (blind spots) kept to a minimum, behavioral patterns can be more easily detected. Market surveillance platforms can make thematic reviews easier by allowing firms to build a case by grouping potentially related alerts, with the option of adding comments.

This provides the ability to build a case picture or visualization of events over an extended period of time, by either a trader, client or algorithm.

Past mistakes

As stated above there are still gaps in compliance with the REMIT /MAR regulations, most specifically in the area of monitoring intent of potential market abuse. Some firms are perhaps considering building their own in-house systems, though history has shown that this mistake is fraught with danger (as recent record-breaking regulatory fines have shown). Vendor market surveillance solutions that are specifically adapted for dealing with power and gas markets could be an alternative to be considered to give you the peace of mind that all the gaps are indeed covered.

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 cases coming directly from the trading floor in each edition.

Case: Is statistical arbitrage market manipulation?

Trader Jeff is placing orders based on the outcome of the in-house developed models for statistical arbitrage. These models detect arbitrage opportunities based on mispricing between contracts with different trading terms.

Question 1:

The placed orders will be contrary to the current market prices. Could these be considered by the regulator as an attempt to manipulate the market?

What the experts say

First we will take a short look at what statistical arbitrage is. This is a fancy term for pair trading, which is the buying or selling of a pair of contracts based on their relationship or correlation with each other. Often, the contracts or markets follow one another very closely.

A pair or spread trader observes the relationship between two markets or contracts and buys or sells whenever the relationship gets out of sync, acting on the assumption that the historical correlation is likely to continue. If this actually happens the trader will make a profit, if not he will realize a loss.

Examples of statistical arbitrage are:

- Arbitrage Week Ahead and Day Ahead Prices
- Arbitrage different periods; e.g. different Months, Quarters vs. Years etc.
- Arbitrage between Day Ahead (auction) and Intraday (continuous) markets;
- Arbitrage between 2 or more different markets; for instance the Clean Spark (power vs. Gas and carbon price)and Dark Spread (power vs. Coal plus carbon price)"

Generally a statistical arbitrage consists of three parts:

1. Obtaining arbitrage pairs:
2. Establishing the spread series
3. Setting trading thresholds and stop limits

If executed in this way statistical arbitrage is a valid trading strategy and should not be considered as an attempt of market manipulation. To be able to answer an inquiry by a regulator, you should keep clear accounts of the outcomes of the model and why you placed the orders contrary to the current market conditions.

Question 2:

Would it make a difference whether the strategy is executed in a liquid or illiquid market?

Probably so for the regulators to launch an investigation. Statistical arbitrage works in liquid markets, but probably much better in illiquid markets. But could also have a much higher impact on the results in an illiquid market and thus might be flagged as a susceptive trading strategy by the regulators.

Executing statistical arbitrage trades in an illiquid market therefor requires an even more careful approach.

Do you also have a question for this column?

Send it to: walet@maycroft.com

Order Form

Yes, I subscribe to the **Energy Compliance Intelligence Series**

I choose the following subscription:

☐Quarterly € 150 per 3 months

☐Annual € 495 per year

Please check the box of the option of your choice

Contact details

First and Last name:

Function:

Company:

Address:

City:

Zip code:

Country:

E-mail:

Telephone:

VAT number:

Date, Place and Signature:

Please return to: office@maycroft.com