Energy Compliance Intelligence Series

Regulation and Trading Compliance for Energy Firms

Your Monthly Update

Issue 3, November 2016

Table of Contents November issue

- From the editor 3
- Selecting a Trade Surveillance solution 4
- News from the Regulators 7
    - MiFID II escape strategies for energy traders
- Investigations
    - Cases under investigation by ACER end Q3 8
    - JPMorgan paid $410 Million in settlement
- Questions from the Trading Floor 15
    - Case: Transactions in illiquid markets

From the editor

Although the start of MiFID II has been delayed until January 3, 2018, you as an energy trading company should be very curious to learn what the impact of the financial regulation is going to have on your company. At the moment of writing it is still not clear what the exact ruling is going to be for getting an exemption to MiFID II. We describe the latest status of MiFID II in regulatory process as well what might be possible ways to escape MiFID II.

One thig is for sure you have to start thinking about your strategy, because from experience I know that companies tend to start way to late with their preparation and therefore could be caught short in time.

Good business!

Amsterdam, November 2016

Kasper Walet

Managing Director, Maycroft

Email: walet@maycroft.com
Tel: +3165381819

Selecting a Trade Surveillance solution

ACER and the national regulators have stepped up enforcement of energy trading regulations. As a result you are forced to play catch-up in improving the quality and responsiveness of your own trade surveillance program. Part of this strengthening in capability will inevitably lead your company to consider automated surveillance as one of the tools in your compliance operating model. The challenge will be to know what solutions are the most appropriate and pragmatic.

ACER and the national regulators are getting faster at identifying possible manipulation and abuse. Some energy trading companies have responded by implementing new trade surveillance systems. But these systems are often installed 'as is', so without the customization needed to properly reflect the specific operating features of the power and gas trading markets or the nuances of an individual firm's risk and product profile.

Where to look for guidance? The regulations themselves give little guidance. So while REMIT stipulates that firms should not enter into market abuse, it does not state what the expectations are in terms of 'best practice' to prevent it, leaving you with difficulty as to how to prove that you are compliant. Ultimately, you need capabilities which are proportionate to the risk on your portfolio, but there is little for energy companies to benchmark themselves against. The only industry you could look at to learn valuable lessons is the financial services sector where transaction surveillance functions have been relatively commonplace for many years.

Nevertheless, there are some areas of the rulings which are very clear, such as the fact that firms must not enter into abusive behavior (and what constitutes this is broadly defined) and that firms must notify the relevant regulators as soon as they become aware of a potential incident.

To be able to do this this, you will need to have a robust monitoring capability in place to identify incidences of abuse and detect events for reporting to the regulators, in line with your obligation. In addition, you should consider the broader implications for your organization should there be an allegation of market abuse made against you. Reputational damage can be huge and penalties are increasingly severe, resulting in large fines, loss of license to operate or in some jurisdictions even imprisonment for senior company personnel.

The approach of a compliance function so far varies across energy trading firms. At the most basic level, firms may routinely inspect simple reports of trading activity and market prices, or undertake periodic 'spot checks'. However, these approaches are resource intensive and unreliable due to the high degree of human interaction and interpretation required. A more robust approach is to adopt an automated transaction surveillance tool, as part of the wider compliance framework.

How to be able to make a well-informed decision about what solution to choose? First you will have to decide where your firm wants to be on the compliance spectrum. At one end, you may choose to meet just the minimum regulatory requirements, such as the trade clearing and reporting requirements stipulated by EMIR, MAR and REMIT. At the other hand , there may be a clear commitment to demonstrate best practice to regulators, customers and counterparties, building comprehensive capabilities but requiring deeper investment. The reality probably will be that you will be somewhere in the middle of these 2 extremes. However, one thing should be very clear before you can decide about a surveillance system, you must develop a good understanding of where specifically the regulatory risk lies in your portfolio and hence, the depth of capability they require.

There are some key steps that you should take to get a thorough understanding about what trade surveillance tools would be best for your company:

- Understand the true compliance risk on your portfolio. Typically, this would involve upfront analysis which considers each class of traded product in the portfolio, and features of the product which might make it high risk from a compliance perspective. This would include the volume of trading activity, market dominance, degree of regulation of the product etc.
- The types of market abuse scenario which could realistically occur on the portfolio should also be considered.

This analysis phase is a critical step to choosing a solution which is proportionate to the needs of your business and should be undertaken before any system selection or implementation activities are commenced.

The findings from the analysis activity should provide a strong steer regarding the priority in which to address the different products, helping to shape a trade surveillance roadmap. Also practical delivery considerations should be taken into account.

There is much benefit in taking a phased approach to the implementation of your trade compliance function. Clearly there is a balance to be met between starting with the simplest products yet ensuring that areas with the highest compliance risk are addressed first. Such a phased implementation approach also gradually builds the knowledge and skills of your compliance function. In addition, it gives a degree of flexibility should the prioritization change at a later date due to an evolving regulatory landscape or a change in internal prioritization.

There are, of course, other beneficial reasons to consider transaction surveillance:

- The presence of such a capability within your organization would demonstrate to regulators and counterparts, a commitment to the detection and prevention of market abuse by your company.

- It also acts as an internal deterrent – the knowledge that trading activities are being monitored will most certainly make traders more cautious about their behavior.

- Finally, trade surveillance tools hold a wealth of data about patterns and trends in the traded markets. This information can be exploited for commercial analysis, empowering your firm with a deep source of market intelligence which can be employed by many functions within the business, not just the compliance function.

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 escape strategies for energy trading companies

Energy companies may soon find it more difficult to hedge risk as a result of EU reforms that seek to clamp down on speculation in commodity derivative markets. MiFID II reforms, now due to take effect January 3, 2018, would require that all such traders adhere to strict position limits to prevent a buildup of dominant positions. A subset would be required to hold a MiFID II "license" and maintain similar capital and liquidity reserves as banks. Traders may struggle to maintain capital reserves, which could reach $6.7 billion per company.

Companies that deal in commodity derivatives currently benefit from a number of MiFID exemptions from rules aimed at banking, on the basis that they do not pose a comparable systemic risk. In MiFID II, however, these exemptions have been narrowed. Without being able to make use of such exemptions, energy trading firms could end up being treated as de facto financial institutions.

The "main business threshold" test, which compares a company's speculative and proprietary trading, doesn't measure trading against a company's whole business, contrary to political agreement. The rules may be amended to revert to a "capital employed" test to determine if funds used in commodity derivatives trading are ancillary to the main business, as initially proposed in 2014.

Recently Markus Ferber, the lead parliamentary politician on the implementation of the financial regulation announced that the European Parliament negotiating team have some "very last concerns" on commodity position limit rules expected to be finalized soon, according to Markus Ferber, the lead parliamentary politician on a key piece of financial regulation.

Market participants are waiting for the European Commission to finalize some crucial technical rules, known as Regulatory Technical Standards (RTS), ahead of the entry into force of the second Markets in Financial Instruments Directive (MiFID II) in January 2018. After the commission adopts the RTS, these will be subject to a scrutiny period in which the parliament and EU Council could raise objections before they enter into force.

The RTS rules will define the in/out tests that traders will have to pass in order to avoid being licensed as an investment firm, and the size of a position any one party will be able to hold in a particular derivative or economically-equivalent over-the-counter contract.

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. If they can prove their trading activity is ancillary to their main business, they will be exempted. If they will be captured, they will need increased capital reserves which will ultimately lead to higher costs to trade.

Commodity market liquidity may wane due to MiFID II rules that could push commodity trading firms, and companies that trade ancillary to their main business, to exit the market. Buffers, position limits and compliance costs would exacerbate this. With fewer counterparties, the market may suffer reduced liquidity, volatility spikes and wider bid-ask spreads.
For energy traders, a key concern with MiFID II is the potential loss of exemptions from financial services rules enjoyed by energy trading firms, and new position limits for commodity derivatives generally.

Potential MiFID II escape strategies

Ever since it became clear energy firms would be drawn into the net of new European Union financial regulations, they have been dissecting the rules in search of a way out.

Potential strategies to avoid MiFID II include cutting back on commodity derivatives trading activities that could be considered speculative; pushing those activities into a separate unit; or even relocating them outside of Europe altogether.

Yet another potential solution is to switch from derivatives trading to physical transactions, executed on a different kind of platform where trades are exempt from the rules. Non-multilateral trading facility, or non-MTF, platforms might allow firms to trade power and gas without worrying about MiFID II.

But the devil is in the details – and nobody quite knows whether the non-MTF platforms available will really provide energy firms with a get-out-of-jail-free card.

On July 1, the newest non-MTF platform was launched by the EEX. The platform lists a suite of physically settled power and gas derivatives. These are not considered as financial instruments under MiFID II, according to EEX.

That is an important point, because if EEX's new suite of products do not fall within the definition of financial instruments, an EU energy firm that trades them would not need to count them towards the so-called 'ancillary business exemption' thresholds. Firms that cross these thresholds would be dragged into the scope of MiFID II.

Before EEX launched its new platform, the non-MTF space was largely the purview of European energy brokers. Brokers such as ICAP, Griffin Markets, and GFI have offered non-MTF execution of physical power and gas trades for the past several years, having introduced them ahead of a previous regulatory deadline – the February 2014 launch of trade reporting under EMIR.

The significance of the OTF venue type is that MiFID II will remove natural gas and power forwards executed on OTFs from the definition of a financial instrument, as long as they "must be physically settled". The rationale behind the exemption is that such trades are already covered by REMIT, the so called "REMIT carve out". So physically settled transactions on OTFs have emerged as a potential escape hatch for utilities, commodity trading firms and other physical market participants
unhappy about MiFID II.

Unlike MTFs, which must be non-discretionary in nature, OTFs use discretion in the process of lining up buyers and sellers – for example, in deciding when to place or retract an order. The launch of the EEX non MTF or OTF platform has raised controversy among market participants. Some are skeptical about the legitimacy of EEX's new venture. Critics say it uses a central limit order book to match trades, just like an exchange, and they argue that such a platform should not be considered discretionary. By allowing such a platform to be classified as an OTF, they say, regulators could create an uneven playing field between brokers and exchanges.

In the end the National Regulators will have to decide about their interpretation of the term discretion and thus about the acceptance of OTFs as an MiFID II escape route.

Investigations

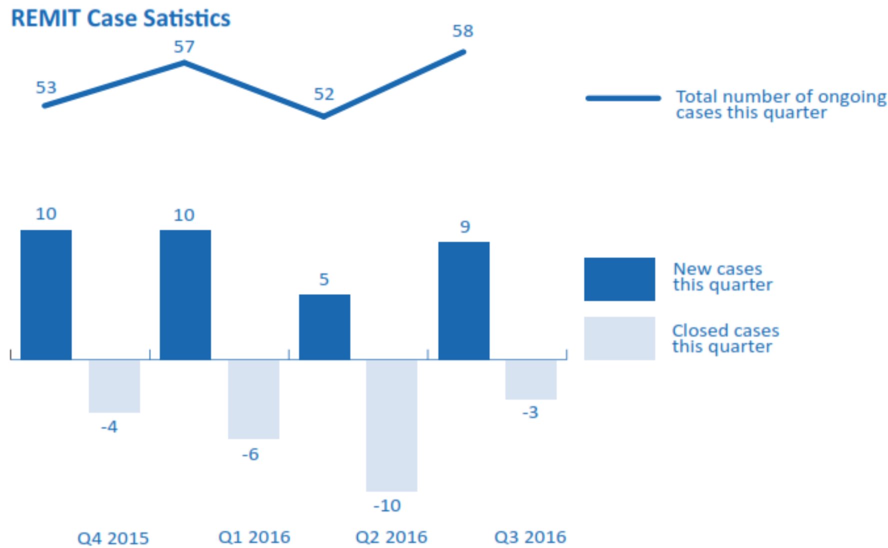
Below is a description of the number of REMIT cases under investigation by the end of October of this year. Besides there is a description of another US case from which valuable lessons could be learned.

Cases under investigation by ACER per the end of Q3, 2016

At the end of the third quarter of 2016, ACER had 58 REMIT cases under review. REMIT cases are potential breaches of REMIT that are either notified to ACER by external entities or discovered by ACER through its surveillance activities.

A case could, after a thorough investigation by the relevant national authority, lead to sanctions. A case could also be closed without sanctions, for instance if the suspicions were unfounded.

The table below shows the number of cases that were under review by the ACER in the last four quarters. Unfortunately we do not know any details about these cases under investigation.



JPMorgan paid $410 Million in U.S. FERC Settlement

In 2013 JPMorgan Chase paid $410 million to settle U.S. Federal Energy Regulatory Commission (FERC) allegations that the bank manipulated power markets, enriching itself at the expense of consumers in California and the Midwest from 2010 to 2012.

The bank agreed to pay a U.S. civil penalty of $285 million and return $125 million in ill-gotten profits to electricity ratepayers.

"JPMorgan picked the pockets of California households and businesses, and their manipulation increased the electric bills that people pay," Tyson Slocum, director of the energy program at Public Citizen, a Washington-based consumer advocacy group, said in an interview yesterday.

At the time, the settlement was a record for the FERC since Congress gave it additional powers to police energy markets in 2005, after the collapse of energy trader Enron. JPMorgan's $285 million civil penalty is the largest paid to the regulator by any company.

The FERC assessed a $435 million penalty to Barclays Plc for alleged market manipulation, which will be a record if it is paid. The company has vowed to challenge in court.

“JPMorgan’s brazen, Enron-style market manipulation cost California ratepayers over $120 million,” Representative Henry Waxman, a California Democrat, said in an e-mail. “Congress provided FERC with the authority to stop precisely these kinds of fraudulent schemes.”

The FERC said a JPMorgan energy-trading unit engaged in 12 bidding strategies in wholesale energy markets from September 2010 to November 2012, resulting in tens of millions of dollars in overpayments from the grid operators. The agency announced the violations yesterday after investigating the bank’s energy-trading practices for more than a year.

The settlement with the FERC ends the agency’s investigation of J.P. Morgan Ventures Energy Corp., a trading unit overseen by commodities chief Blythe Masters. The wholly owned subsidiary trades and holds physical commodities, including agricultural products, metals and energy, as well as derivatives.

The settlement released JPMorgan, all subsidiaries and employees, including Masters, from any future enforcement actions by FERC in this case.

The bidding strategies at issue were developed by a Houston-based unit run by Francis Dunleavy, who was one of eight people who reported directly to Masters.

Dunleavy was a Bear Stearns veteran who joined in 1982 before rising to become one of its senior energy executives. In 2005, as Bear Stearns lagged energy-trading rivals such as Goldman Sachs and Morgan Stanley, Dunleavy helped lead a venture with power producer Calpine Corp. that traded natural gas and electricity.

JPMorgan inherited Bear Stearns’ energy trading operations when it purchased the company in 2008. Dunleavy oversaw Andrew Kittell and John Bartholomew in the company’s principal investments unit beginning in 2010.

All three men are still employed by JPMorgan although they no longer have a role in bidding for energy in California’s power market, according to the FERC. Marchiony declined to comment on their current roles or whether the company would cut their bonuses or Masters’ compensation.

The three traders didn’t agree to a settlement with the FERC, Gibson, Dunn & Crutcher LLP, the law firm representing Dunleavy, Kittell and Bartholomew, said in a statement.

The agency decided not to pursue sanctions against them after they explained to the FERC that their conduct was lawful, it said.

“The commission’s decision to voluntarily settle with JPMorgan and not proceed against the individuals can only be read as the commission correctly concluding that no case or findings against the individuals could be sustained in a court of law,” William Scherman, their lawyer, said in the statement.

Already before the settlement FERC revoked the unit’s right to trade power for six months after accusing the firm of providing misleading information to regulators. The suspension marked the first such sanction for an active market participant.

FERC investigators focused in part on “make whole” payments that grid operators pay to generators if the sale of electricity doesn’t yield enough revenue for the company to recover its startup costs.

The agency’s investigation covered two periods, September 2010 to June 2011 and March to November 2012. JPMorgan’s energy-trading unit was engaged in 12 strategies to manipulate markets in California and the Midwest, 10 of which began while the investigation was underway, the FERC said.

The company’s traders offered to provide electricity at relatively low rates in forward markets, then offered to provide it at 120 percent of the clearing price in real-time markets, Eric Hildebrandt, director of market monitoring for the California Independent System Operator told reporters.

This strategy meant that JPMorgan’s power plants weren’t chosen to provide service, even though it allowed the company to receive payments to recover startup costs from the grid operator for making the units available.

FERC stepped up scrutiny of corporations as the agency wields policing powers that were expanded in the wake of Enron’s 2001 collapse. The regulator ordered Barclays Plc and four of the company’s former traders to pay a combined $487.9 million in fines and penalties for engaging in what the agency said was a scheme to manipulate energy markets in the Western U.S. from 2006 and 2008. The bank has vowed to fight the penalties.

Deutsche Bank AG agreed to pay $1.6 million to resolve FERC claims that an energy-trading unit manipulated markets in 2010. The Frankfurt-based bank didn’t admit or deny wrongdoing.

The agency fined ex-Amaranth Advisors LLC trader Brian Hunter $30 million in 2011, ruling he manipulated the price of contracts on the New York Mercantile Exchange in 2006 while boosting the value of financial derivatives. A U.S. Court of Appeals ruled in March that FERC lacked the jurisdiction for the fine.

The FERC in March 2012 reached a then-record $245 million settlement with Constellation Energy Group Inc. over alleged energy trading violations in New York. Constellation didn’t admit any wrongdoing.

Lessons to be learned

Although the judicial system as well the practices in the US electricity markets are somewhat different than in Europe, still there are valuable lessons to be learned from this case.

First of all the sheer size of the settlement amounts; hundreds of millions of US Dollars. The fines will probably not as excessive as they will be in our region, but still we can expect very significant fines in Europe as well. As was also shown by the fine Iberdrola received.

Another conclusion we can draw is how difficult it is for FERC and any regulator to relate misconduct back to individual traders.

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: Potential false/misleading transaction in illiquid markets

James is the gas prompt trader and trades anything from prompt up to BOW. James places orders at different levels; 1/ 2euros lower/higher than where the actual buying or selling interest in the market is expected to be. Still James gets hit on those 'just in case' bids/offers.

Question 1

Is placing these orders allowed, especially if you do not really know the market price due to the fact that it is illiquid?

What the experts say:

Particular with natural gas you have to make a clear distinction between liquid and illiquid market places. If it is on let's say TTF or NBP, in other words highly liquid markets, this strategy would most likely not raise any red flag.
However, doing this on an illiquid market is very dangerous. As if there are no executed trades the closing price might be determined based on the bids and offers that are actually below or above the 'real market 'price level. So this could be considered as market manipulation and regulators might launch an investigation. Even if the bid and /or offer was a mistake this could be considered as market manipulation.

Question 2

If your bid/offer has been on the screen for let's say a few hours, can it be interpreted as market manipulation?

What the experts say:

This actually would be the same answer as to question 1. The sheer fact that the bid/offer is on the screen for such a long time, without being amended would be held against you in case of a claim that this was a mistake. Particular if the closing price will be determined based in the bid/offer.

Lessons to be learned:

So the conclusion is that with trading in illiquid markets or products traders should be extra careful in placing bids and offers and avoid mistakes. The latter could still have an impact on the market price and put it an artificial level.

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