

# The Long-Arm Reach of Regulators in the Energy Markets

Energy commodity trading is a globalised business, with high risks and rewards. One of the main attendant risks is that, in an increasingly borderless world, trading operations need to have an evolving and fluid insight into how the major regulators understand the concept of 'jurisdiction' – in many ways, this forms the key to managing and avoiding regulatory risk.

By Doron Ezickson, Kate Learoyd & Prajakt Samant

**THE ENERGY COMMODITY** trading arena inevitably attracts far more regulatory oversight than many other commodity sectors. There is an overwhelming political sentiment in the US that market speculation has contributed to disproportionate rises in energy prices. As Senator Levin said, following the recent publication of the Levin-Coleman Report, "It's time to put the cop back on the beat in our major energy markets".

A recent example of heightened regulatory oversight was the action launched by the Commodity Futures Trading

Commission (CFTC) against BP for allegedly manipulating the physical propane market in 2003 and 2004. BP has been charged with 'cornering the market' in physical propane. Dominant commodity traders, of course, have strategies to own or lease gas or power storage facilities to afford them the flexibility of holding onto inventory and selling it at commercially fortuitous moments. However, regulators will make the (sometimes nebulous) distinction between placing such bets on the basis of fundamental supply and demand market mechanics, and the intentional manipulation of the relevant markets. In this instance, in order to prove manipulation took place, the CFTC would need to prove that the trader intended to affect the price, had the ability to do so, and caused an artificial price movement as a result of his actions.

In July 2006, the CFTC brought to an end its lengthy investigation of historic price manipulation in the copper markets by imposing a US\$150 million penalty on Sumitomo Corporation. The facts alleged were that a Tokyo-based trader employed by Sumitomo maintained dominant positions in copper and copper futures on the London Metal Exchange. This allegedly led to artificially inflated prices on the worldwide copper markets, including the US. This is a clear example of how a US regulator clearly can, and will, impose penalties on trading activities taking place outside the US to protect its domestic markets.

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The Sumitomo case demonstrates that a purely domestic approach to the regulation of commodity trading – in any sector – is rarely appropriate. Trading activities carried out or strategies executed in one jurisdiction are capable of having profound repercussions in overseas markets.

The CFTC is one agency which has ruffled feathers by indicating that there may be circumstances where an exchange based outside the US (a so-called 'foreign futures exchange') may need to be treated (for regulatory purposes) as a US exchange. To many in Europe, this approach points to an unwelcome cross-border regulatory 'creep'. This issue arose as a result of the existence in London of an energy futures exchange owned by ICE (ICE Futures), a US incorporated operator, regulated by the UK Financial Services Authority (FSA) offering contracts in the US which are not subject to the CFTC's regulatory oversight. The 'offending' contract in question is the futures contract in West Texas Intermediate Crude Oil (WTI). The CFTC has allowed ICE Futures to offer its WTI contract to US traders under the 'no-action letter' procedure. This is a form of negative clearance/comfort letter provided by the CFTC to allow foreign exchanges access to US markets without requiring them to be designated a US exchange.

## Levin-Coleman Report

The Report, published on 27<sup>th</sup> June 2006, was commissioned to address recent concerns over record high energy prices, which, it is thought, may pose a future threat to US economic and energy security and diversity. The Report examines recent trends in the commodities markets which appear to point to the US government and its enforcement agencies taking a less proactive role in monitoring US energy markets which has, in turn, led to some questioning of whether energy prices accurately reflect supply and demand rather than market manipulation or excessive speculation. As Senator Levin said, following the recent publication of the Report: "Enron has already taught us how energy traders can manipulate prices and walk over consumers if they think no one is looking and they can get away with it."

The Report concluded that overly speculative conduct by market participants has contributed to the rising oil and gasoline prices, and that too many energy trades are occurring without appropriate regulatory oversight. One of the major recommendations of the Report was that Congress should enact legislation to eliminate the so-called "Enron loophole", which currently delimits the CFTC's oversight of key US energy commodity markets, to put the CFTC back in charge of policing these markets more aggressively.

*[The authors of the Report – were Senators Norm Coleman, Chairman of the Senate and Permanent Subcommittee on Investigations, and Carl Levin, Ranking Minority Member (at the time of writing)].*

The full text of the Report is available at:  
[www.senate.gov/~levin/newsroom/release.cfm?id=257862](http://www.senate.gov/~levin/newsroom/release.cfm?id=257862)

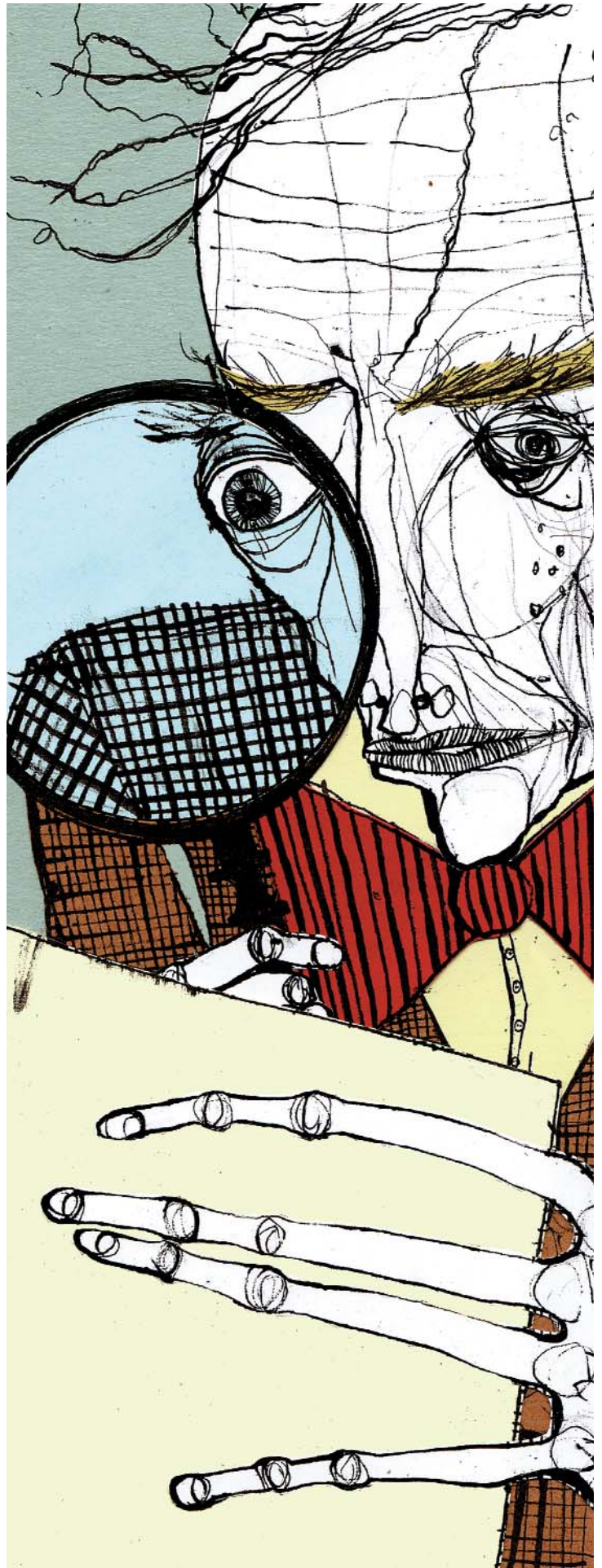
However, the FSA is taking a similar approach to the CFTC over the extent of its jurisdiction. The FSA recently confirmed that it has jurisdiction over conduct amounting to market abuse committed on overseas exchanges. The context of the decision (*FSA v Jabre v GLG Partners*) was market abuse committed by a hedge fund manager. The trades in question were shares issued by a Japanese bank, traded on the Tokyo market. The FSA imposed large fines for market abuse even though no abusive trading activity took place in the UK itself. These fines were upheld by the Financial Services and Markets Tribunal (the Tribunal) which held that the FSA had jurisdiction over the case, because the securities were also admitted for trading on a UK exchange, even though the abusive trades took place in Tokyo. The Tribunal commented that, if the FSA only had jurisdiction over market abuse cases where the abusive trades took place on the London market, an individual who received inside information in London could trade elsewhere, for example New York, on the basis of his insider information. This approach would severely constrain the FSA's power to regulate the London

#### Jabre & GLG Partners FSA Decision

The leading hedge fund manager Philippe Jabre, and the hedge fund which formerly employed him, GLG Partners, were each fined £750,000 by the FSA for market abuse in August 2006. The decision related to trades in Japanese stocks which took place in 2003.

In 2003, an investment bank made a routine sales call to Mr Jabre relating to a forthcoming bond issue for Sumitomo Mitsui Financial Group (SMFG). The bank told Mr Jabre that his ability to trade in SMFG was restricted as a result of receiving the information. However, Mr Jabre proceeded to short sell SMFG shares worth US\$16 million in eight successive trades on the Tokyo stock market. The FSA charged both Mr Jabre and GLG Partners with market abuse.

Mr Jabre referred several aspects of the case to the Financial Services and Markets Tribunal. He unsuccessfully contended that the market abuse regime did not apply as his trades occurred outside the UK on the Tokyo market. This argument was based on the wording of the legislation (s 118 FSMA) which states that market abuse is behaviour "which occurs in relation to qualifying investments traded on a market to which this section applies". The Tribunal held that the fact that SMFG shares were also listed on a UK market was sufficient to give the FSA power to bring proceedings in the UK. It is therefore clear that market abuse can be committed in respect of trading activities outside the UK, if the investments in question are traded on a UK market.



markets, and would consequently hinder international policing of such unlawful trading practices.

In the energy commodities context, the *Jabre* case suggests the FSA will have wide jurisdiction over misconduct committed on overseas exchanges. Energy commodity based securities (e.g. oil futures) are generally uniform and traded on numerous international exchanges. Therefore, the corollary of this is that the FSA is likely to have jurisdiction to prosecute market abuse over energy commodity trading committed outside the UK on foreign markets where the security is admitted for trading on a UK market (or where some equivalent UK nexus can be established).

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In the *Jabre* case, the FSA recognised that it needed to utilise its extra-territorial reach in order to be an effective regulator of globalised markets. It is difficult to discern where the line will be drawn in future. However, the recent highly controversial extradition of the 'NatWest Three' – three UK citizens formerly employed by Natwest – to Houston, Texas on charges of allegedly defrauding their UK employer has starkly highlighted the fact that individuals and corporations can be subject to regulatory or criminal sanctions imposed outside their home jurisdiction.

There is a sense in all of this that areas such as energy commodities are too critical to both the domestic and international economies to be left to the energy commodity markets and its players alone. The regulators are watching and there is a growing realisation on their part that they must exercise some extra-territorial powers in order to effectively regulate their domestic markets. As recently stated jointly by the Fed, the FSA and the SEC: "...in a more integrated global market, we will increasingly find ourselves compelled to pursue borderless solutions. In the case of derivatives, a local or national solution would have been insufficient to protect domestic financial markets from the risks posed by market practices".

Whilst, practically speaking, no measure can ensure that a company does not fall foul of the regulators, a robust corporate compliance programme will at least go some way towards detecting and preventing untoward conduct. In other words, the main aim of any compli-

ance programme must be to prevent or mitigate any exposure to regulatory risk, and to ensure staff are sensitised to the fact that regulators can (and increasingly will) "pursue borderless solutions" to deal with any infringements.

An effective compliance programme would incorporate substantive knowledge of UK and US regulators and how their interpretations of concepts and standards such as 'market manipulation' and 'jurisdiction' are ever-shifting. Furthermore, given the current trend and the instances outlined above, it would appear that the US and UK regulators are flexing their extra-territorial muscles, and the markets are bound to see greater incidence of this along with greater inter-regulator cooperation and dialogue (for example, as demonstrated between the FSA and the SEC over the proposed merger between the NYSE and Euronext.Liffe) •

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