

# Adopting the US Standard –

## How Compliance has been pushed to the frontline for Commodities Trading Companies in the UK & Europe

This article looks at standards for compliance expected from US CMPs and how, for various reasons, many UK and other European CMPs now find themselves falling within the reach of US regulators. It then focuses on the benefits CMPs could obtain by evaluating and evolving their own compliance regimes, both in order to achieve the US-standard, and to address other developments in the international landscape.

By **Doron F. Ezickson & Adam Topping**

**IN LIGHT OF** the requirements imposed on them by increasingly aggressive US regulators – including the Commodity Futures Trading Commission (CFTC), Federal Energy Regulatory Commission (FERC), Federal Trade Commission (FTC) and the Department of Justice (DoJ) – commodity market participants (CMPs) in the US now find themselves operating in one of the world's toughest regulatory environments. In order to ensure they do not fall foul of the regulators, US CMPs must be able to clearly demonstrate the pervasive role that legal compliance plays in their business.

Whilst not yet commensurate with the enforcement activities of the US regulators, the increased politicisation of the oversight of financial and commodities markets, and recent pronouncements by UK and EU regulators, mean that CMPs must prepare for a more aggressive policing of the markets, by way of increased monitoring, investigations and enforcement activities. Prudent European CMPs will not leave compliance to chance, but rather will establish a clear culture of compliance within their organisation. This suggests adoption of a compliance regime, fit-for-purpose in the world's toughest regulatory environment: the US.

### **Favourite Offences**

Regulators are on the lookout for a range of offences related to manipulation of markets. Particular favourites are allegations of intentionally creating an artificial price in the energy markets, or circulating false information in the market that may affect the price of a commodity. Whether or not an offence has occurred will not always be clear-cut.

However, there are a range of practices that the regulators inevitably end up focusing on, such as activities that appear to stretch the rules, or have no other economic rationalisation. When these practices are drawn to the attention of regulators via, for example, unusual market activity, a competitor, or perhaps an ill thought out email or statement, this can and often will incite further requests for information and/or investigations. While avoidance of these activities may seem obvious, time and again it is precisely these practices that trigger the investigations that lead to the front-page headlines that can be so damaging to the operations and reputation of a company. In order for CMPs to reduce susceptibility to scrutiny as a result of their trading activities, it is essential to create a proactive compliance culture and processes.

### **What is the US Standard?**

In the post-Enron world of US commodities trading compliance is king. The ongoing financial crisis has only served to heighten the sense of the regulators to the need for CMPs to instil ever more rigorous compliance programmes. Much government rhetoric during the crisis has had an air of political dogma to it, reflecting a perception held by sections of the public that the actions of CMPs have been in part responsible for the volatility that has effected commodity prices (and increased costs to end-users) in recent years.

Aggressiveness on the part of the US regulators is taken for granted by US CMPs. When you expect regulators to be looking for any opportunity, actual or perceived, to go after any market participant, the higher profile the better, the implementation of a robust compliance regime becomes an essential prerequisite to doing business. Whilst not all CMPs will

### **Commodity market participants must prepare for a more aggressive policing of the markets**

have in place identical compliance regimes, there nevertheless are enough similarities to allow observers to identify the core “best practice” elements that constitute the US-standard. A compliance programme should be focused on three main areas: implementation, detection and mitigation. Firstly, a CMP should implement training and policies that result in the avoidance

### BOX I: Essentials of a Compliance Regime

1. A set of compliance guidelines or manual, that set out and explicitly ban unauthorised or illegal activity, focus on who the relevant regulators are, what those regulators are responsible for, and how to avoid risk and conduct business in a way that does not fall foul of their rules, regulations and other laws;
2. Putting in place firm-specific, bespoke written standards of conduct, provided to all energy personnel, and incorporating 'principle-based' guidelines within which employees are expected to operate;
3. An affirmative statement from employees to maintain an ongoing awareness of regulatory rules and developments, and to engage only in legitimate competitive activity;
4. To act in accordance with the firm's core principles, and to operate within the spirit, not merely the letter, of the law;
5. An affirmative requirement for personnel to raise questions and concerns with management, legal or compliance, especially with respect to trading activities in a new or changing regulatory area;
6. A price reporting policy to govern reporting procedures to price indices;
7. A document retention and retrieval policy;
8. A detailed set of risk control policies, specifically designed to detect improper trading. Such policies should allow for, at a minimum, the routine review of large trades, trades above or below market price, all transactions at a net level, as well as any apparently offsetting transactions;
9. A hotline for anonymous reporting;
10. Regular and independent internal audits of trading activities and of the compliance regime itself.

of problematic behaviour. Secondly, if problematic behaviour does occur, internal mechanisms should allow for the swift detection of such behaviour, thus allowing a CMP to be proactive in its response. Thirdly,

... commodity market information is now routinely shared between different regulators

if a government or regulator does find a violation, the CMP needs to be able to mitigate any penalties to the largest extent possible.

So what, in practice, does the US-standard consist of? CMPs must be able to demonstrate that compliance

is at the forefront of everything they do, impacting upon and guiding the execution of transactional, legal, credit, auditing, accounting and other business decisions. In practice, in order to satisfy the regulators, a compliance regime will need to include, at a minimum, ten key factors (BOX I).

Compliance and training will be overseen by a chief compliance officer, a position which maintains operational independence from the trading operations. The chief compliance officer's role will be multifaceted, but generally will involve developing and providing detailed, mandatory in-house compliance training for all staff, from front, middle and back-office employees, right up to senior management on the board; designing and operating a compliance monitoring regime and implementing procedures for remedial action; dealing with compliance issues, maintaining a compliance log, liaising with local counsel, where appropriate, and recommending disciplinary actions for those in breach of firm guidelines.

### Compliance in the UK & Europe

In recent years particularly, European CMPs have increasingly been finding themselves exposed to US regulatory risk, and hence coming under pressure to have their compliance regimes conformed with the US-standard. Originally, this

arose when European businesses were looking to set-up trading operations in the US. This process gave them direct exposure to the US, and required them to develop compliance programmes to satisfy their new market regulators.

Meanwhile, the impact of the US regulators has continued to grow. They have become more aggressive in their enforcement activities, imposing substantial fines on CMPs. They also have been paying less attention to international borders, asserting something akin to 'intergalactic' jurisdiction over the commodity markets. If a trading activity has an effect on US markets, and the US regulators believe such activity to be illegal, then they can and often will launch enforcement proceedings against the alleged perpetrator, regardless of where the party is located or the offence took place.

Moreover, agreements to facilitate the sharing of commodity market information are now in place between different regulators both within the US and with their European equivalents, including from the UK, France, Germany, Ireland, Spain, the Netherlands and Italy. In addition to this, in 2011, an EU-wide

Agency for the Co-operation of Energy Regulators will be created. While the precise remit of this new agency is still being finalised, it is ultimately likely to play an international supervisory and regulatory role. This demonstrates an increasing realisation by the European Commission of the need to develop and maintain a consistent approach to energy market regulation across the EU. CMPs will no doubt be closely monitoring developments in this area.

In the UK, the ongoing financial crisis has resulted in an increased focus on the role of the regulators and a corresponding expectation on them to enhance their investigation and enforcement of market abuse. This has resulted in a hardening of the stance and increased activity from the UK financial services regulator, the Financial Services Authority (FSA). In 2009, the FSA handed out record fines. In March 2010, the FSA also announced a new penalties policy that could see fines treble in size, and, according to Margaret Cole, its Director of Enforcement: “will reap rewards in terms of an increase in compliant behaviour”.<sup>1</sup>

This renewed focus on enforcement from the regulators (or “credible deterrence” in the words of the FSA), in conjunction with information sharing arrangements in place, make it almost certain that, even if unusual and potentially damaging trading activities are not initially picked up by a CMP’s ‘home’ state regulator, at some stage it will be picked up somewhere, and then come to the attention of someone who is willing to investigate further. When the regulators do become aware of such activities, there can (and likely will) follow investigations, and possibly enforcement action.

All of these factors have served to sharpen the focus on compliance, not just for European businesses with a US nexus, but also for those wanting to put themselves beyond reproach in the event that the regulator comes knocking.

### Bribery Compliance

An area where compliance issues have been gaining increased prominence recently, is with respect to bribery laws. For a long time, US companies, as a result of the *Foreign Corrupt Practices Act* (FCPA), were subject to what were widely considered the most stringent anti-bribery compliance requirements in the world. As the FCPA focused on US entities and citizens, there



was not a requirement on the part of non-US entities without a US nexus to implement similar compliance procedures. Many nevertheless chose to do so, a policy which allowed them to project an image to

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investors and the outside world of a company maintaining the highest ethical standards.

The focus on anti-bribery compliance has intensified in recent months. Firstly, recommendations

were published by the OECD specifically targeting bribery. Amongst other things, the OECD brought a renewed focus onto facilitation payments (small payments made for the purpose of expediting a routine official process, which were expressly carved out of the FCPA).

Following from the OECD recommendations, the UK government recently passed the Bribery Act 2010. This new legislation goes further than the FCPA in many ways, and includes an outright ban on facilitation payments by any entity on UK soil, and by UK entities on foreign soil. The law also requires implementation of compliance procedures. In light of the OECD recommendation, it seems likely that other countries will follow suit with similar rules. The practical effect of the new legislation will be for entities with a UK nexus that previously only were FCPA-compliant, to expand and update their policies in accordance with new UK Bribery Act.

The new rules will apply to all businesses, and should therefore also form a core part of a CMP's bespoke compliance regime.

### Benefits of Compliance

The benefits of implementing rigorous compliance (including anti-bribery) systems include enhanced market integrity and oversight, a reduction in operational, trading and counterparty risk, and increased transparency. It also saves a firm money, protects its professional integrity and reputation, and reduces the chances of it having its conduct questioned and examined by regulators with 20/20 hindsight. When it comes to defending an enforcement action, it is not a defence to say that a certain type of behaviour was "market practice". In the past, many firms have been penalised for conduct that was commonplace at the time it was carried out. Regulators also have tended to

look more favourably upon companies that have implemented and enforced a serious compliance programme. This can be the difference between a criminal or civil offence, can affect the type of charges brought, and the relative size of any fine. Under recent proposed guidelines published by FERC, where a CMP is found guilty of wrongdoing, the punishment to which they are subjected will be increased or decreased depending on certain key "culpability" factors, including: the degree of senior management involvement and an organisation's acceptance of responsibility; the organisation's history of violations; the organisation's compliance and ethics programme; and the extent to which the organisation self-reported the violations. The CFTC has also brought actions for failure to properly supervise trading activities.

### Risks of Non-Compliance

Failure to adopt complete compliance procedures can have severe consequences for the CMPs and their officers, especially where individuals operating within such entities are found to have behaved in breach of the laws. In the US, criminal penalties include multi-million dollar fines and up to 10 years imprisonment per offence. Civil penalties can include fines of US\$1m per day per violation, or triple the monetary gain, restitution, cease and desist orders, or extended, and possible lifetime, prohibition from trading.

### The focus on anti-bribery compliance has intensified in recent months

Since 2002, the CFTC has obtained over US\$2.5 billion in penalties, restitution and disgorgement from market participants. Similarly, following the passage of the Energy Policy Act of 2005, FERC has significantly expanded its enforcement programme.

Businesses suffer indirectly as well. The mere release of information concerning alleged wrongdoing or sanctions into the public domain can result in billions of dollars being lost from a firm's market capitalisation. Even if CMPs have not done anything wrong, the costs, both in terms of manpower and money, of investigating allegations of wrongdoing can be huge. Regulators will ask for emails, telephone recordings, instant messengers, and a whole range of other documents, much of which may not be related to the allegations. There is likely to be an element of robust back and forth between the investigator and the CMP, as to the legitimate scope of any request (time consuming in its own right). Regardless of the rights and wrongs, the end result is inevitably a huge document review exercise, diverting time and attention and money away from the core business. Often, key traders and managers are also taken away from the business and required to submit to government interviews or depositions.

### Conclusion

The continued aggressiveness and extraterritorial focus of the US regulators, together with the toughening stance being adopted by UK and European regulators as to the need to step-up their enforcement activities, and the various information sharing arrangements in place between US and European regulators,

means that European CMPs are under ever-increasing pressure to implement rigorous compliance regimes.

Moreover, the constantly evolving international landscape, highlighted by the soon to be created EU-wide Agency for the Co-Operation of Energy Regulators, and the enactment and extra-territorial effect of the UK's Bribery Act, means that CMPs need to ensure they constantly monitor and keep abreast of the whole gamut of regulatory developments – not just in their own country, but in any where they are doing business. Failure to do so could potentially expose them to extensive regulatory risk, and, in the event that any wrongdoing does occur, the penalties for CMPs, and their officers and employees, can be huge.

Implementing a US-style compliance regime, with the necessary European provisions, provides a CMP with a strong platform from which to manage these risks, and demonstrate to the regulators that it takes its compliance function seriously. •

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**Footnote:**

1. [www.commodities-now.com/news/portfolio-management/1916-fsa-finalises-new-framework-for-financial-penalty-setting.html](http://www.commodities-now.com/news/portfolio-management/1916-fsa-finalises-new-framework-for-financial-penalty-setting.html)