

# **STAFF WHITE PAPER ON EFFECTIVE ENERGY TRADING COMPLIANCE PRACTICES**



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# Staff White Paper on Effective Energy Trading Compliance Practices

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## I. Introduction

The primary goal of the Commission's enforcement program is compliance. Over the years, the Commission has provided guidance on developing and maintaining strong compliance programs that are focused on ensuring observance of the Commission's various rules and requirements through a variety of orders, policy statements, and technical conferences. As part of that guidance, the Commission has consistently emphasized that there is no one-size-fits-all approach to compliance. For that reason, the Commission has not mandated or recommended the adoption of any particular compliance program or compliance practices. Nonetheless, market participants continue to seek more detailed guidance, especially with respect to compliance with the Commission's Prohibition of Energy Market Manipulation.

The purpose of this White Paper on Effective Energy Trading Compliance Practices (White Paper) is to respond to those requests for additional guidance by providing examples of compliance practices that have been effective in detecting and deterring market manipulation and of compliance practices that have been ineffective.<sup>1</sup> While the practices described in this White Paper are consistent with the principles set forth by the Commission in its previous statements on compliance, its objective is to go a step further by providing concrete examples of compliance practices, procedures, training, and review that will assist electric energy and natural gas market participants in designing, implementing, and maintaining strong compliance programs.<sup>2</sup>

## II. Background

The Energy Policy Act of 2005<sup>3</sup> authorized, among other things, the Commission

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<sup>1</sup> While this White Paper focuses on providing examples of practices that, if implemented properly, may be effective in preventing and detecting market manipulation, many of the compliance practices described herein may also be generally effective in ensuring compliance with the Commission's other statutes, regulations, and orders.

<sup>2</sup> It is important to note that adopting the effective practices described herein will not shield an organization from, or provide a defense to, an enforcement action if the Commission concludes, after an evaluation of the facts and circumstances involved, that it committed a violation. However, if an organization has an effective compliance program in place at the time of a violation, the penalty for such violation could be reduced. *See Enforcement of Statutes, Orders, Rules, and Regulations*, 132 FERC ¶ 61,216 (2010) (Revised Policy Statement on Penalty Guidelines).

<sup>3</sup> Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005) (EPA Act 2005).

to issue rules prohibiting market manipulation under the Federal Power Act (FPA) and the Natural Gas Act (NGA) and granted the Commission new civil penalty authority under the NGA<sup>4</sup> and enhanced civil penalty authority under Part II of the FPA<sup>5</sup> and the Natural Gas Policy Act of 1978 (NGPA).<sup>6</sup> Since receiving this additional enforcement authority, the Commission has reiterated its commitment to promoting compliance with the statutes that it administers and the rules and orders issued thereunder. Consistent with this view, the Commission has issued a number of Policy Statements that provide guidance as to how organizations should design and implement their compliance programs and has emphasized that “[a]chieving compliance, not assessing penalties, is the central goal of our enforcement program.”<sup>7</sup>

Soon after Congress enacted EAct 2005, the Commission issued its first Policy Statement on Enforcement in October 2005, which emphasized the importance of developing strong compliance programs as a way to prevent violations and to reduce civil penalties if a violation were to occur. It listed a number of factors that would be considered in determining whether to provide mitigation credit for compliance efforts in any penalty decisions.<sup>8</sup> These factors include the nature and structure of a company’s compliance program, the active support of senior management, the scope and depth of employee training, a process for auditing compliance, and the response of a company to misconduct by its employees.<sup>9</sup>

In May 2008, the Commission issued a Revised Policy Statement on Enforcement, which reiterated the compliance factors described in the first Policy Statement and elevated the importance of compliance programs by making clear that, among all the factors considered, “the most important in determining the amount of the penalty are the seriousness of the offense and the strength of the entity’s commitment to compliance.”<sup>10</sup>

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<sup>4</sup> 15 U.S.C. § 717t-1 (added by EAct 2005, § 314(a)(1)).

<sup>5</sup> 16 U.S.C. § 825o-1 (2000) (as amended by EAct 2005, § 1284(e)); 16 U.S.C. § 823b (2000).

<sup>6</sup> 15 U.S.C. § 3414(b)(6) (2000) (as amended by EAct 2005, § 314).

<sup>7</sup> *Compliance with Statutes, Regulations, and Orders*, 125 FERC ¶ 61,058, at P 1 (2008) (Policy Statement on Compliance).

<sup>8</sup> *Enforcement of Statutes, Orders, Rules, and Regulations*, 113 FERC ¶ 61,068, at P 21-23 (2005) (Policy Statement on Enforcement).

<sup>9</sup> *Id.* P 22.

<sup>10</sup> *Enforcement of Statutes, Regulations, and Orders*, 123 FERC ¶ 61,156, at P 54 (2008) (Revised Policy Statement on Enforcement).

In the Revised Policy Statement on Enforcement, the Commission emphasized the importance of organizations having “(i) systems and protocols for monitoring, identifying and correcting possible violations, (ii) a management culture that encourages compliance among company personnel, and (iii) tools and training sufficient to enable employees to comply with Commission requirements.”<sup>11</sup>

After holding a Technical Conference on Compliance on July 8, 2008 and receiving comments from market participants, the Commission issued a Policy Statement on Compliance on October 16, 2008. The purpose of that Policy Statement was to provide additional guidance on compliance with the Commission’s statutes, regulations, and orders. The Policy Statement focused on four factors related to effective compliance that the Commission takes into account in considering whether to reduce or eliminate civil penalties. These factors are: (1) the role of senior management in fostering compliance; (2) effective preventative measures to ensure compliance; (3) prompt detection, cessation, and reporting of violations; and (4) remediation efforts.

Most recently, in March 2010, the Commission issued a Policy Statement on Penalty Guidelines that sets forth a guidelines-based structure for assessing civil penalties that is based on the Federal Sentencing Guidelines.<sup>12</sup> After receiving industry comments on these Penalty Guidelines, the Commission issued a Revised Policy Statement on Penalty Guidelines in September 2010 that maintained the guidelines-based structure of the previous Policy Statement, but made changes to the guidelines to address some of the comments it received.<sup>13</sup> These Penalty Guidelines provide for substantial and transparent mitigation credit to those organizations that demonstrate that they have an effective compliance program.<sup>14</sup>

For an organization’s compliance program to be deemed effective under the Penalty Guidelines, an organization must: (1) exercise due diligence to prevent and detect violations; and (2) otherwise promote an organizational culture that encourages a commitment to compliance with the law.<sup>15</sup> The Penalty Guidelines then set forth seven factors that must be accounted for by a compliance program in order to receive full credit

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<sup>11</sup> *Id.* P 57.

<sup>12</sup> *Enforcement of Statutes, Orders, Rules, and Regulations*, 130 FERC ¶ 61,220 (2010) (Policy Statement on Penalty Guidelines).

<sup>13</sup> Revised Policy Statement on Penalty Guidelines.

<sup>14</sup> FERC Penalty Guidelines § 1B2.1.

<sup>15</sup> *Id.* § 1B2.1(a).

as an effective compliance program. These factors include requirements related to establishing standards and procedures to prevent and detect violations, overseeing the compliance program, excluding those employees who have engaged in violations from positions of substantial authority, training employees and disseminating compliance-related information, having mechanisms in place to ensure that the compliance program is followed, promoting compliance through incentives and disciplinary measures, and responding appropriately to violations that are detected.<sup>16</sup>

Each of these Policy Statements focuses on developing and maintaining programs that promote compliance with the Commission's statutes, regulations, and orders generally and how the existence of such programs can mitigate a civil penalty assessment if an organization commits a violation. Each subsequent Policy Statement built upon its predecessors and provided greater detail and guidance, while maintaining the view that each organization is in the best position to evaluate the compliance risks that it faces and to design a compliance program that best addresses those risks.

This White Paper supplements the Commission's Policy Statements. Its purpose is to enumerate compliance practices that, in staff's view, are effective in preventing and detecting one specific type of violation, market manipulation. The specific practices discussed herein are not required to be established and followed for an organization to receive compliance credit under the Penalty Guidelines if a violation occurs. Therefore, while the existence of these practices in an organization's compliance program may factor positively into the Commission's consideration of whether the organization's compliance program was effective, the presence or absence of any one of these practices would not be determinative of the program's effectiveness. This White Paper is being issued simultaneously with a White Paper on Anti-Market Manipulation Enforcement Efforts Ten Years After EAct 2005.<sup>17</sup>

### **III. Development of Effective Trading Compliance Practices**

Since EAct 2005 was passed ten years ago, the Office of Enforcement (OE) has reviewed the trading activities of a number of market participants in the natural gas and electric markets. Staff conducts surveillance to identify possible misconduct and has reviewed individual market participant behavior to uncover potentially manipulative

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<sup>16</sup> *Id.* § 1B2.1(b).

<sup>17</sup> *See* Office of Enforcement White Paper on Anti-Market Manipulation Enforcement Efforts Ten Years After EAct 2005, Nov. 17, 2016 (The Anti-Market Manipulation White Paper). The Anti-Market Manipulation White Paper is available on the Commission's website.

conduct. Through this experience, staff has developed an enhanced understanding of how to detect potential market manipulation.

Staff has also reviewed and evaluated a variety of compliance practices that are geared towards preventing traders from engaging in market manipulation, some that are successful and others that are not. Staff regularly requests compliance-related documents and information during investigations to evaluate whether the subject of the investigation had an effective compliance plan in place at the time of the alleged manipulation. Often, the subjects of investigations will make improvements to their compliance programs after the investigation highlights deficiencies. Sometimes these compliance program changes are agreed to as part of a settlement agreement, but other times the subject will institute them on its own initiative. If compliance improvements are included in the terms of a settlement, the Commission will usually also require the organization to report on its compliance program for a designated period of time after the settlement. Staff reviews these reports to monitor the organization's overall compliance program and to ensure that the organization is making improvements consistent with the terms of the settlement. This review provides staff with insights into how organizations implement new compliance practices and a better sense of the resources and time required to do so.

In addition, staff has conducted outreach to gain additional insight on compliance practices from a variety of compliance professionals. Staff met with representatives from both large and small companies engaged in various aspects of the electric and natural gas markets as well as experts in trading compliance and energy market manipulation. Staff also met with consulting firms that work with companies on improving their compliance programs. The corporate compliance representatives shared their experiences developing and maintaining compliance programs, including which practices they view as effective for their respective organizations, which practices appear ineffective, the resources required to develop and maintain their compliance programs, and the challenges they have overcome. Staff has used its experience and the input it received from those industry representatives to develop this list of effective trading compliance practices.

#### **IV. Effective Trading Compliance Practices**

For any compliance program to be effective, the organization must have a culture of compliance. Promoting a culture of compliance starts at the top, with a Chief Executive Officer and other executive officers who are committed to compliance and who demonstrate that commitment through action. The organization and the executive officers must be committed to promoting compliance at all levels by devoting the necessary resources to the organization's compliance activities, implementing and enforcing rules and restrictions that are appropriate for the organization's activities, ensuring that employees understand their compliance obligations, and continually assessing the effectiveness of the compliance practices.

The effective compliance practices described below are divided into three categories: (A) designing an effective trading compliance program; (B) establishing, implementing, and enforcing effective practices to deter and detect market manipulation and other misconduct; and (C) assessing the performance of the compliance program on a regular basis. Staff recognizes that not all of these practices will be appropriate for every organization and that there are likely other compliance practices, not included in this list, that are also effective or that may be more appropriate or effective for a particular organization. However, these compliance practices have proven to be effective for a number of organizations and should provide useful guidance to organizations that are designing new compliance programs or those that are evaluating and improving their existing compliance programs.

## **A. Designing an Effective Trading Compliance Program**

A compliance program must have a strong foundation to be effective. This involves making the appropriate decisions relating to: (1) the organizational structure and composition of the compliance function; (2) human resources issues, such as hiring standards, compensation, and discipline; (3) the types of training used to disseminate compliance information; and (4) the technological resources dedicated to the compliance function.

### **1. Organizational Structure and Composition**

Staff has observed that organizations with effective trading compliance programs often have compliance personnel with a variety of expertise, including legal, operations, risk management, and trading. It is important that compliance personnel not only have an in-depth knowledge of the legal and regulatory requirements within which the organization operates, but also how the organization's business units operate on a day-to-day basis. The following practices could assist an organization to meet this goal:

- *Hire compliance personnel with a variety of professional and educational experience, including legal, operations, risk management, and trading.* While it is important for compliance personnel to know and understand the legal requirements that apply to its organization's trading activities, it is equally important for compliance personnel to have an in-depth understanding of the organization's trading activities. This knowledge should include, for example: (1) which products the organization trades in which markets; (2) the products each trader is permitted to trade; and (3) an understanding of the characteristics of the products traded and how those products function, such as how they settle and relate to each other and the potential market impacts of the trading. This diverse knowledge and experience helps to ensure that compliance personnel are able to provide the appropriate advice to the organization's trading personnel. Moreover,



it also assists compliance personnel in explaining the organization's trading activities to senior management and Commission staff.

- *Integrate compliance personnel into the organization's business units.* This integration can be accomplished by, for example, physically locating compliance personnel among the traders (*i.e.*, on the trading floor) and regularly rotating business unit employees into compliance. By including an organization's compliance function and its personnel in the day-to-day activities of the organization's trading operations, compliance personnel are more accessible to trading personnel and traders may be more willing to ask questions, seek advice, and follow the advice given by compliance. This integration also assists compliance personnel in staying apprised of the business units' activities and individual employees' roles within the organization. Rotating business unit employees into compliance could also foster a mutual understanding of and respect for the two functions.
- *Empower compliance personnel to succeed.* Compliance personnel should have the authority to implement compliance procedures, report compliance failures, and remedy those failures or deficiencies without interference from the business units. This may be accomplished by structuring the organization in a manner that gives the compliance function a direct reporting line to the Chief Executive Officer or to the Board.<sup>18</sup> Moreover, compliance personnel should have the authority to require trading personnel to heed their advice. If compliance personnel provide advice on a particular matter or issue, traders and business unit managers should not be permitted to ignore that advice unilaterally. Instead, the organization should establish documented procedures to resolve any disagreements between compliance and the trading operation.
- *Provide compliance personnel with adequate resources to establish, maintain, and evaluate the organization's trading compliance program.* It is essential that compliance personnel have access to the necessary resources to ensure compliance. An organization can provide the necessary resources by ensuring that its compliance function has sufficient funding to: (1) hire the requisite number of employees with the appropriate skills and experience; (2) provide adequate compensation and incentives to recruit and retain skilled compliance personnel; (3) invest in technology resources to monitor trading, trader communications, and compliance with internal controls; (4) evaluate, on a regular basis, the ongoing effectiveness of the organization's compliance program; and (5) maintain, update, and improve the organization's compliance-related technology resources.

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<sup>18</sup> See FERC Penalty Guidelines § 1B2.1(b)(2)(C).

- *Encourage compliance personnel to network with other compliance professionals.* There are a number of industry and compliance-related associations that provide a forum for their members to discuss compliance-related issues and to share their experiences. Organizations should encourage their compliance personnel to participate in these associations. This interaction will strengthen the organization's compliance program because it allows compliance personnel to share ideas with and to get advice from other compliance personnel in the same industry.

## **2. Human Resources**

An organization's recruitment and hiring standards for energy traders and its compensation structure play important roles in ensuring that a compliance program is effective. Even if an organization has employed experienced compliance personnel and has a comprehensive trader monitoring structure in place, noncompliance may still occur if the organization's traders do not have the inclination or incentives to make compliance a priority. Therefore, it is important for an organization to hire traders that are able and willing to learn and adhere to the rules that apply to their trading activities. The organization should also implement a trader compensation structure that incentivizes compliance, not just profitability. The following human resource-related practices could assist an organization in meeting these goals:

- *Perform background investigations on energy traders.* Performing background investigations as part of the recruitment process for new traders allows the organization to determine whether any of the candidate's prior professional or personal conduct might indicate a willingness or incentive to violate rules (*e.g.*, criminal activity, civil lawsuits, federal investigations, drug abuse, excessive gambling, or financial difficulties). Updating current employees' background investigations on a regular basis is also a useful method of informing the organization of any new, potential issues in an employee's personal life that could impact his or her professional performance. Used properly, background investigations can play an important role in reducing the risk of trader noncompliance.
- *Check on a candidate's compliance track record as part of the recruitment process.* When checking professional references from previous trading positions, requesting a reference from the previous employer's compliance department and asking a candidate's former supervisors about the candidate's compliance track record can assist the organization in choosing traders who will make compliance a priority. Such questions might include: (1) Did the trader ever violate internal compliance restrictions? (2) Was the trader ever disciplined for noncompliance? (3) Did another employee ever allege that the trader violated a rule? and (4) Did

the trader complete all required compliance training on a timely basis? During the recruitment process, an organization could also inquire into the candidate's knowledge of the Commission's regulations that would apply to his or her activities. This inquiry would not only assist the organization in assessing whether the candidate should be hired but also in tailoring new employee training to fill in any identified knowledge gaps.

- *Implement a compensation structure that incentivizes compliance.* Including a compliance component in an organization's compensation structure helps to prevent traders from focusing on profitability to the detriment of their compliance obligations. Examples include a structure that: (1) requires adherence to compliance-related rules and restrictions in order for a trader to be eligible for a performance-based bonus; (2) includes a separate bonus for those traders who have a strong record of compliance; and (3) reduces a trader's performance-based bonus for any compliance-related violations that occurred throughout the year.<sup>19</sup>

### 3. Training

Regular training is an essential element of an effective trading compliance program as it is intended to provide traders with up-to-date knowledge of all of the rules and requirements that apply to their trading activities.<sup>20</sup> There are a variety of different training methods and styles that organizations can choose from, so it is important that the training program used by an organization is appropriate for: (1) the organization's size; (2) its trading activities; and (3) the experience level of its traders. It is also important that training is offered frequently enough that traders are aware of any changes in rules or requirements that apply to them on a timely basis and that they do not become lax in their compliance obligations. Here are training practices that might assist an organization in meeting these goals:

- *Tailor the training program to the organization's specific trading activities.* While using training that is specifically tailored to an organization's trading activities might have more up-front costs than standardized training, it also offers a number of benefits. For example, traders are likely to be more actively engaged in training that directly applies to their activities than training that only partially relates to their work. Tailored training may also involve business unit managers and include specific examples of compliance-related issues that might arise in the course of their trading. In addition, tailored training might actually be less time-

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<sup>19</sup> See *id.* § 1B2.1(b)(4)(A).

<sup>20</sup> See *id.* § 1B2.1(b)(2)(C).

consuming than off-the-shelf training as it would minimize superfluous information.

- *Combine a variety of training styles.* When developing a training program, it is important to recognize that different employees will learn in different ways. Therefore, by offering compliance training in a variety of different methods and styles, the organization is more likely to meet the learning needs of its employees. An appropriate combination of different training styles might include, among others: (1) small group trainings that facilitate more discussion than larger group sessions; (2) one-on-one meetings between a trader and a member of compliance staff; (3) annual large group training that emphasizes general compliance guidelines; (4) newsletters with compliance updates or required reading; (5) question and answer sessions; (6) regularly updated compliance reference manuals; and (7) computer-based training with embedded quizzes.
- *Utilize frequent, topic-specific training.* An organization could offer short, weekly or monthly training sessions that focus on a specific topic. These sessions could focus on rule changes or recent issues that the organization has faced. Providing these frequent training sessions might assist an organization in keeping its traders focused on compliance, while maintaining their attention during the training sessions. They may also provide an easy forum for discussions between compliance staff and traders.
- *Disseminate new information in a timely manner.* The Commission frequently issues new rules, orders, policy statements, and settlements that provide important information for compliance personnel and traders. An organization's compliance program should include a mechanism for tracking and disseminating this new information in a timely manner to ensure that both compliance personnel and traders have the most current information available to them. Such mechanisms might include, among others: (1) compliance alert emails that summarize the new information and explain why it is important to the traders; (2) periodic newsletters that provide updates from the prior newsletter; and/or (3) periodic staff meetings that highlight important compliance information.
- *Track participation in training.* Regardless of whether a training exercise is mandatory or voluntary, organizations should track their traders' participation in the different training exercises that are available. Tracking participation will assist compliance personnel in evaluating whether their training sessions are working and whether voluntary sessions should be mandatory. It will also assist the organization in determining whether its traders are committed to staying informed of their compliance obligations.

- *Enforce training requirements.* Just like all other compliance-related activities, it is essential that an organization be committed to enforcing any training requirements that it sets for its traders. If a trader does not meet his or her training requirements, then the organization might subject that trader to discipline, such as: (1) suspending the trader until all mandatory training is complete; (2) deeming the trader ineligible for a performance-based bonus; and/or (3) increasing supervision of the trader’s trading activities.

#### **4. Information Technology Resources**

Information technology (IT) resources are a valuable compliance tool. They can be used to track participation in compliance training, monitor trader activities, and detect potential compliance violations and market manipulation. For that reason, it is important that organizations commit sufficient resources to their compliance programs to purchase, maintain, and operate IT resources that will make their compliance programs more efficient and effective. Practices that might assist an organization in providing its compliance program with the necessary IT resources include:

- *Budget for compliance-specific technology resources.* Compliance personnel should not have to compete with the business units for one IT budget or for the use of existing IT resources. Therefore, organizations might find it useful to allocate funds specifically for compliance-related IT resources to ensure the business units are not given priority access to all IT resources.
- *Regularly evaluate and update IT resources.* It is important for organizations to evaluate the IT resources available to their compliance personnel, including how well those resources meet their objectives, whether any of them require updating, how often they are used, and whether compliance personnel use the resources properly. And, when appropriate, the organization should update those IT resources to take advantage of any new technological advancement or to reflect new regulatory or tariff requirements.

#### **B. Establishing, Implementing, and Enforcing Effective Practices to Deter and Detect Market Manipulation and Other Misconduct**

One of the compliance areas in which staff observes organizations struggle the most is in monitoring their traders’ activities to identify potential misconduct. This difficulty partially comes from the fact that organizations must allocate limited resources across a wide variety of trading activities. The complexity of energy products and trading activities, especially in the electric markets, also makes it difficult for compliance personnel to understand trading activities well enough to monitor for misconduct. However, there are a number of different compliance practices that organizations can

utilize to make it much more difficult for a trader to engage in misconduct and to detect such behavior when it occurs.

As a starting point, implementing some or all of the practices described above in designing the organization's compliance program will reduce the risk that the organization's traders will engage in misconduct and put the organization in a better position to monitor the traders' activities. From there, the organization should: (1) establish appropriate rules and restrictions for its traders that will further reduce the risk of misconduct; (2) consistently monitor trading activities for violations of those rules and for any other suspicious activity; and (3) strictly enforce all compliance rules and follow up on all potential issues.

### **1. Establishing Appropriate Trading Rules and Restrictions**

An organization can reduce the risk of trader noncompliance with the Commission's rules and orders by placing appropriate restrictions on their trading activities that are designed to limit the traders' ability and incentives to manipulate or engage in other misconduct. Organizations can protect themselves against instances of noncompliance by requiring compliance personnel to stay informed of the regulatory requirements that apply to the organization's trading activities, assess those activities to identify areas that present the greatest risk of noncompliance, and then design trader restrictions to help to minimize or eliminate those risks. The following list provides examples of rules and restrictions that an organization might use, depending on its particular trading activities, to reduce the risk of trader noncompliance with Commission rules and orders:

- *Maintain a list of prohibited trading strategies.* Compliance personnel can draw from their own experience, the experience of the organization's business unit managers, and the Commission's settlements, orders, and other statements to develop a list of prohibited trading strategies. This list would include trading strategies that the Commission has deemed to be improper and trading strategies that compliance views as improper based on similarities to known manipulative schemes. Compliance should update the list regularly to reflect new information from Commission orders and settlements, changes to their trading operations, and market changes. And, as discussed in more detail below, compliance should monitor the traders' activity to ensure that they are not engaging in any of the prohibited strategies.

- *Document trading strategies.* Documenting trading strategies helps compliance understand the traders’ activities and provides an easy reference for conducting a review of the organization’s trading activities.<sup>21</sup>
- *Require approval for new products and locations.* Requiring traders to obtain approval from compliance, their managers, or both, before trading new products or at new locations provides compliance and the business unit managers with an opportunity to vet the traders’ new trading strategies and determine whether they would provide an opportunity to engage in misconduct. As part of this approval process, it may also be helpful to require the traders to describe their purpose for trading the new products to assist in determining whether approval is appropriate. This approval process also notifies compliance of potential new areas in which trader monitoring might be necessary prior to the commencement of the activity.
- *Implement restrictions that discourage or prevent traders from using price-setting instruments to benefit open financial positions.* Many of the Commission’s market manipulation enforcement actions, investigations, and settlements have involved market participants using a price-setting instrument (*e.g.*, physical natural gas products, physical electric products, and virtual transactions) to move a price (*e.g.*, natural gas index price or a day-ahead market locational marginal price) in order to benefit a leveraged financial position (*e.g.*, financial natural gas or electric swaps). There are a number of policies that an organization can use to prevent its traders from engaging in this type of manipulative scheme. A list of examples of such policies includes:
  - *Require documentation of any trading strategies involving related physical and financial positions.* One way to discourage traders from using physical energy products to benefit financial positions is to require documentation of all trading strategies that involve trading related physical and financial products. This documentation should explain the rationale for the strategy (*e.g.*, a hedge) and describe the circumstances under which the strategy might be used. Organizations can also consider using book structures that align with the business rationale for particular trades, such as reporting trades in an asset hedge book.
  - *Establish limits on persistent losses in price-setting instruments.* In some cases, these types of manipulative schemes involve the trader enduring

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<sup>21</sup> Compliance personnel should be diligent in checking the accuracy of such documentation to ensure that traders cannot hide misbehavior behind misleading explanations of their trading strategies.

persistent losses in the price-setting instrument in an effort to move the relevant price in the direction that benefits his or her related financial position. To limit a trader's ability to sustain persistent losses, an organization should consider setting limits on the number of days that it permits its traders to sustain losses on certain price-setting instruments. Such a limit, if appropriately chosen, may make it difficult for the trader to push the relevant price in the desired direction.

- *Establish position limits for financial products.* Limiting the size of a trader's open financial positions can minimize the trader's incentive to try to move a price to benefit his or her financial positions. Compliance personnel should also monitor for and be aware of traders shifting positions to other traders or books in an attempt to evade such limits.
- *Establish thresholds for concentration levels in physical and virtual trading products that trigger compliance review.* An organization can limit a trader's ability to move a price to benefit his or her financial position by setting thresholds on his or her trading of a particular product at a particular location. The thresholds should be set to a percentage of the overall market activity in that product and at that location. Exceeding such a threshold would trigger compliance review of the trading to determine whether the trader had a legitimate explanation for exceeding the threshold. An organization could also establish thresholds for its virtual traders' net nodal virtual volumes that are tied to the average load at the relevant node. Such thresholds could help prevent the traders from trading in a volume that would have an impact on the targeted price and it could also limit the losses that the trader might take on the price-setting instrument.

## **2. Monitoring Trading Activities**

Once an organization has identified areas of potential noncompliance and set rules and restrictions for its traders, it is essential that it monitor trading activities to ensure compliance with those rules and restrictions.<sup>22</sup> There are a variety of different monitoring methods that could prove effective for an organization, including automated surveillance tools or algorithms that analyze trade data and communications to identify potential compliance issues. Recognizing that each organization has unique characteristics and resources, it is best for an organization to develop its own individualized monitoring plan. However, no matter which monitoring tools an organization decides to implement, it is important that those tools are used routinely and

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<sup>22</sup> See FERC Penalty Guidelines § 1B2.1(b)(5)(A).



that all potential issues are taken seriously. Moreover, the organization should continually assess the monitoring tools that it utilizes to determine whether they continue to be effective at detecting potential issues. The following list provides examples of monitoring techniques and practices that have proven effective for some organizations:

- *Perform statistical reviews of position concentrations.* Monitoring an organization's trades and position concentrations in particular markets and products can assist compliance personnel in identifying areas in which a trader might have the ability to push a price in a direction that could benefit a related financial position. This review should be in the context of specific markets, as well as the behavior of other participants and locations to account for differing liquidity and the market participant's ability to influence prices. Organizations can also track financial exposure to determine which trades may need additional review by compliance. If the position in the financial instrument is larger than for the price-setting instrument, compliance may want to review this trading.
- *Perform reviews of trader activities at locations where traders engage in both physical and financial trading.* As discussed above, trading both physical and financial products at the same or related locations presents a risk of traders engaging in a manipulative scheme that involves both products. For that reason, organizations should document the locations at which traders trade both physical and financial products and regularly review their trading at those locations to ensure that they are not using the physical trading to benefit a financial position. Compliance personnel could conduct these regular reviews on a sampling basis, using criteria set by compliance to choose the sample, or using automated surveillance tools with alerts and a follow-up process for reviewing those alerts. For example, an automated surveillance alert could be generated when a trader is below or above prevailing prices with a high market concentration.
- *Perform reviews of trader activities in the organized electric markets at locations where traders engage in both virtual and other financial trading.* Similar to the discussion of physical and financial products above, trading both virtuals and financial products (e.g., financial transmission rights or electric swaps that settle off real-time or day-ahead market locational marginal prices) at the same or related locations presents a risk of traders engaging in a manipulative scheme that involves both products. Therefore, organizations should also document the locations at which traders trade both virtual and other financial products and periodically review their trading at those locations to ensure that they are not using the virtual trading to benefit a financial position.
- *Track and review profit and loss calculations for each product and location combination.* As the Commission has stated, uneconomic or persistent, loss-generating trading can be an indicium of manipulation. While there are a variety

of different ways to look at profits and losses (PnL) that may be appropriate for monitoring a trading operation's overall profitability (e.g., aggregated across a portfolio, a time period, locations, or products, etc.), it is important that compliance personnel track and review profitability at a sufficiently granular level to identify misconduct. For example, if a trader is engaging in a scheme that involves losing money in a price-setting product, such as virtual transactions in an organized electric market, to benefit a financial position that is settled off of the price being targeted, an effective way to identify this behavior might be to monitor the trader's virtual PnL, at each location, for persistent losses or a pattern of losses. If, for example, compliance personnel were to track only the aggregate PnL for the portfolio or location, the gains on the financial product might hide the virtual losses, making it more difficult for compliance to identify misconduct.

- *Monitor for changes in the amount and types of make-whole or out-of-market payments the organization receives from activities in the RTO and ISO markets.* A number of Commission settlements, enforcement actions, and investigations have involved market participants providing misinformation or engaging in conduct that provides misinformation to the RTOs and ISOs about their physical characteristics, circumstances, or intentions in order to increase or receive make-whole or out-of-market payments. In order to monitor for such behavior, compliance personnel may track the out-of-market payments that the organization is eligible for as a result of its activities in the RTO/ISO markets and monitor for: (1) significant changes in the amount of payments received; and (2) the commencement of regular or sustained trading which benefits from out-of-market payments. If compliance identifies such changes, it should then evaluate the activity resulting in the payments to determine whether the increased payments resulted from legitimate market conditions, the trading was based on legitimate arbitrage purposes, or if the organization's traders engaged in conduct that was intended to artificially access or increase the out-of-market payments. Indications of improper behavior may include, but not be limited to, unwarranted changes in offer parameters for a generating unit, such as start-up costs or minimum run time, and trading activities that have as their sole or primary purpose access to or collection of an out-of-market payment.
- *Perform periodic reviews of cost-based offers submitted to an RTO or ISO for a generating unit to ensure that the offers are consistent with the applicable market rules.* Depending on the applicable RTO or ISO tariffs, it may be possible for a market participant to adjust its cost-based offers as part of a manipulative scheme in order to limit how often the unit is called to run or to receive or increase out-of-market payments for the unit. To monitor for this behavior, compliance personnel should periodically review the organization's cost-based offers to ensure that they are consistent with the applicable market rules.

- *Perform post hoc analyses of natural gas pipeline nominations and flows during periods of pipeline constraint.* During periods in which natural gas pipelines are constrained, compliance personnel should seek to identify whether nominations made on behalf of the organization were not intended to flow, but, instead, were intended to take advantage of the system, such as to increase pro-rata allocation of capacity during periods of excess nominations or perform uneconomic backhauls. This identification may be accomplished by an after-the-fact comparison of pipeline nominations to flows during the constrained period that looks for opportunistic discrepancies between the two. If any discrepancies are identified, then compliance personnel should follow up with employee(s) responsible for the nominations to understand the purpose of those nominations.
- *Record and retain all trader communications for at least five years.* Trader communications, including emails, instant messages, and phone calls often contain a wealth of information about the traders’ activities, particularly the intent of their trading. Compliance personnel can use these communications to identify traders or activity that present a compliance risk. In addition, trader communications might also be a means of documenting legitimate trading strategies, and therefore, may provide useful information to compliance personnel, if retained. When an organization records and retains trader communications for compliance purposes, staff recommends: (1) requiring traders to use only organization-controlled computers, phones, emails, and instant message services to conduct official business (*i.e.*, prohibit traders from engaging in work-related discussion on personal devices); (2) recording all incoming and outgoing emails, instant messages, and calls; and (3) retaining those recordings for at least five years from the date of their creation.
- *Regularly review employee communications for potential issues or indicators of misconduct.* Organizations that record and retain trader communications should regularly review those communications to identify any potential issues or indicators of misconduct. Depending on the volume of communications that are recorded, reviewing them may be a time-consuming task. However, there are a variety of algorithmic-based software programs that are able to screen communications and flag those that require additional review. Organizations can utilize such programs to make their review of communications much more efficient and productive. When an organization uses such a program, the parameters of the program should be examined and updated frequently to reflect changes in, for example, trading terminology, products, Commission and/or market rules, acronyms and phrases, and the like.
- *Create an environment that encourages employees to discuss compliance concerns and report potential compliance issues without the threat of retribution.* Another valuable resource of information regarding potential trader misconduct is other

employees who may witness, first hand, improper behavior. It is important that an organization encourages its employees to report any potential compliance issues without the threat of retribution. Organizations should also foster an environment in which employees believe that they can ask questions related to compliance and discuss their compliance-related concerns with compliance personnel without the fear of adverse reactions from others within the organization. Organizations should not only proactively protect those employees who ask questions and raise issues from retribution, but they should also make it clear to all employees that they will not face any negative reactions if they report their concerns.

Organizations may also consider a system which permits the identity of reporting employees to be kept confidential from the individuals involved with the alleged misconduct and/or restricted to management-level personnel.

- *Provide a forum for employees to report possible noncompliance.* To encourage employees to report potential compliance issues, some organizations set up an email portal or hotline for employees to report their concerns anonymously. Compliance personnel should follow up on any issues that are raised through such a hotline and document their resolution.

### **3. Enforcing Rules and Restrictions**

All compliance-related rules and restrictions must be enforced to be effective, because traders may not take their compliance obligations seriously if there are no consequences for violations. Enforcement of compliance rules and restrictions includes: (1) following up on all alerts; (2) documenting their resolution; (3) establishing appropriate disciplinary actions for all instances of noncompliance; and (4) disciplining employees for all instances of noncompliance. The following list describes measures that an organization might employ when possible noncompliance is identified:

- *Follow up on and document all alerts of potential noncompliance.* Having a policy of following up on all alerts of potential noncompliance will not only assist compliance personnel in identifying areas of concern, but it also helps to ensure consistent and unbiased application of compliance-related rules. In addition, documenting the steps taken to follow up on alerts provides compliance personnel with a resource for evaluating their compliance procedures and potential risk areas, such as individual employees who frequently cause alerts or certain trading activity that requires closer monitoring.
- *Establish and enforce consequences for noncompliance.* Establishing disciplinary actions for noncompliance helps to deter misconduct and prevent reoccurrence.<sup>23</sup>

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<sup>23</sup> See *id.* § 1B2.1(b)(6)(B).

The different disciplinary actions that an organization chooses to employ should be documented and range in severity based on the seriousness of the corresponding violation. Some examples of disciplinary action include: (1) termination; (2) suspension from trading for a set period of time; (3) additional mandatory compliance training; (4) imposition of stricter trading limitations; (5) negative performance evaluations; and (6) bonus ineligibility. Disciplinary actions must be applied consistently to be effective.

### **C. Assessing the Performance of the Compliance Program on a Regular Basis**

As the Penalty Guidelines state, an organization with an effective compliance program shall take reasonable steps “to evaluate periodically the effectiveness of the organization’s compliance program.”<sup>24</sup> Regular evaluations help to: (1) ensure that the program’s compliance tools continue to be effective; (2) uncover compliance gaps and failures; and (3) identify where updates are necessary. Any issues that are uncovered during these regular performance audits should be documented and addressed quickly.

- *Perform regular performance audits of the organization’s compliance program.* To periodically assess its compliance program, an organization should conduct performance audits. Depending upon the size and business of an organization, the way in which the organization chooses to audit its compliance program may differ. For example, an organization could choose to perform a full audit of its compliance program every two years. Or, an organization may audit one element of its compliance program every six months according to a schedule that ensures that each element of the compliance program is evaluated on a regular basis. Regardless of how an organization chooses to conduct its performance audits, those audits should address the following topics, among others, whether: (1) the training program continues to be effective in ensuring that employees understand their compliance obligations; (2) the organization’s monitoring tools continue to be able to detect potential compliance issues and misconduct; (3) compliance-related IT resources require updating; (4) the process for updating an organization’s compliance materials has been effective at keeping them current; (5) all compliance issues and disciplinary actions have been documented and whether any changes should be made to the organization’s compliance program in light of those issues; and (6) compliance personnel are performing their responsibilities fully.

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<sup>24</sup> *Id.* § 1B2.1(b)(5)(B).

- *Take action on all issues identified in the compliance program’s performance audits.* An essential element of assessing the performance of the compliance program is that the organization uses what it learns during the assessments and makes improvements to its compliance program. As such, an organization should document all of the issues identified during its performance audits and take action to improve the compliance program. Then, in the subsequent performance audit, the organization can evaluate whether any weaknesses still exist in the areas previously identified.

## **V. Ineffective Trading Compliance Practices**

In addition to the many effective practices described above, there are also many ineffective trading compliance practices that staff has observed as part of its investigative and surveillance efforts. These ineffective practices generally reflect an organization’s failure to: (1) tailor its compliance program to the specific needs of its trading operation; (2) keep the compliance program up-to-date; (3) make compliance policies accessible to its employees both literally and from the perspective of employee comprehension; (4) place the appropriate emphasis on ensuring compliance; and (5) follow through on monitoring for violations and enforcing compliance-related rules. These types of compliance failures greatly increase an organization’s risk of violating a Commission requirement. Therefore, staff recommends that organizations do not employ the following types of ineffective practices:

- *Overreliance on standardized and long annual training.* The most effective types of compliance training are those that are tailored to an organization’s trading activities, because they focus on the compliance issues that have a practical application for the traders in their day-to-day activities. When organizations use standardized trainings that cover various topics that may or may not be applicable to the traders’ responsibilities, the traders are less likely to absorb pertinent compliance information from the trainings. In addition, simply re-producing the same training with minor changes each year may be ineffective as employees may become disengaged by the repetitive nature of the training. Moreover, different people learn in different ways. Therefore, relying too heavily on one long, annual training session without also requiring participation in other types of training, such as shorter, frequent, and issue-specific trainings, increases the risk that some traders are not really learning what they need to as part of the training. In addition, it is important that traders receive compliance reminders throughout the year so that they continue to focus on compliance and so that their compliance knowledge is up-to-date. For those reasons, relying too heavily on standardized and annual training, without other types of training throughout the year tends to be an ineffective way to train traders about their compliance responsibilities.

- *Relying too heavily on attorneys for training without including operational staff.* While attorneys who focus on compliance can play a valuable role in an organization’s compliance program and in developing compliance training, it is also important to seek input from operational staff and business unit managers who have hands-on experience with the organization’s trading practices. Operational staff can help tailor compliance trainings and make them more relatable to the traders receiving the training. Compliance training that is solely focused on the legal aspects of compliance without focusing on the practical application of the law is a less effective way to educate traders than integrated training.
- *Providing insufficient funding for the organization’s compliance program.* Organizations often give priority to their trading operations when it comes to resource allocation, because the trading organization is a profit center. While it is understandable that an organization would choose to invest in its trading operation, it is also important to ensure that the investment is not to the detriment of the compliance program. For that reason, an organization’s compliance program should have a separate resource budget that is sufficient to cover all of its needs.
- *Allowing commercial trading staff to overrule compliance advice.* Permitting trading staff or business unit managers to overrule or ignore advice or instruction provided by compliance personnel substantially diminishes the effectiveness of an organization’s compliance program. Therefore, compliance programs should include procedures for resolving disputes between compliance personnel and the trading organization or a process by which the trading organization can seek a reevaluation of an issue when it disagrees with compliance advice. Traders should not be permitted to decide which advice to heed and which to ignore.
- *Overreliance on the use of off-the-shelf compliance tools without customizing them for specific needs.* There are a number of tools available to assist compliance personnel in monitoring trader activity and communications and analyzing trade data. However, these tools need to be customized to the organization’s specific needs to be effective at monitoring for misconduct. Standard, off-the-shelf compliance tools might detect some issues, but they are unlikely to be highly effective without customization to suit the needs of the organization.
- *Failing to regularly reassess and update compliance practices as circumstances change.* The energy markets are complex and ever-changing. Market rules and market conditions change over time and more and different information frequently becomes available. It is important that compliance programs also change and evolve to take into account these changes. Thus, when an organization fails to

reassess and update its compliance program on a regular basis, the risk of non-compliance with the Commission's requirements greatly increases.

- *Setting compliance-related rules, limits, and restrictions and then failing to monitor for violations or discipline those who violate rules in a meaningful way.* An organization can have a compliance program that includes rules and restrictions that, if implemented, could result in a highly effective compliance program. However, implementation is the key to effective compliance. Setting appropriate rules and restrictions is only one step in a multi-step process. The compliance program also should include a robust monitoring plan that consistently monitors trading activity for compliance with the rules and restrictions and a disciplinary component that will deter misconduct and punish those who violate the rules.<sup>25</sup> Rules that are not enforced will not be followed, so organizations should make sure that their compliance programs do not amount to simply “paper programs.”
- *Implementing policies that inhibit or prohibit the retention of trader communications.* Organizations may implement policies that inhibit or prohibit the retention of trader communications for a number of reasons. Such policies can drastically limit the universe of information that compliance personnel have to evaluate a trader's behavior. As discussed above, trader communications might highlight misconduct that was not obvious from trade data, or it might also help explain a trader's activity that appeared to be improper when looking at trade data alone. Another benefit to retaining trader communications is that if the Commission contacts an organization to discuss potential misconduct that it has identified, trader communications can assist the organization in responding to the Commission's inquiry.

## **VI. Conclusion**

The Commission is committed to promoting energy industry compliance with its statutes, rules, orders, and regulations. While it is up to individual organizations to choose which, if any, of the effective compliance practices described herein are appropriate for their compliance programs, this White Paper may assist organizations engaged in trading Commission-jurisdictional natural gas and electric products in developing robust and effective compliance programs that succeed in detecting and preventing market manipulation.

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<sup>25</sup> *Id.* § 1B2.1(a) (“Such compliance program shall be reasonably designed, implemented, and enforced so that the program is generally effective in preventing and detecting violations.”).