Compliance + risk management = value

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Energy insights

At a glance

The silo approach to compliance and risk management is becoming outdated.

Compliance coordinated with risk management is optimal for the new regulatory reality.

And, a unified compliance and risk management program unlocks value.

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Introduction

An overarching compliance program—coordinated with risk management— can protect energy companies from today's new regulatory realities and provide new opportunities for value.

By Thomas Lord and Mark Smith

Ask a dozen business people to define the term "compliance" and you'll likely get 12 different responses, most not quite up-to-date. That's because the conventional wisdom that surrounds compliance—especially in the energy industry—is rapidly changing due to complex regulations, new technology and more aggressive enforcement.

To many in the energy industry, compliance is considered an externally focused function—shielding the company from the scrutiny of outside regulators and legal entities. Compliance is a cost of doing business—an unpleasant necessity. Risk management, on the other hand, is viewed as an internally focused activity, designed to ensure that employees follow the company's policies and procedures. Risk management is often seen as a wise investment that helps ensure the company is being properly managed.

Put another way, risk management is like a security system that the homeowner controls. Compliance is a police officer patrolling the neighborhood. Together, that's a pretty good approach to protecting individuals and property.

Yet at many companies, compliance and risk management don't work in tandem and sometimes don't even share information or data. It's as if the homeowner doesn't want to call the police when the security alarm goes off—or the police don't show when called.

But a confluence of trends is wiping away some of the traditional distinction between compliance and risk management, especially as it relates to the energy industry and the trading of commodities. Smart companies are seeing the real value to creating an overarching compliance function that works hand-in-hand with risk management to protect the company, its stakeholders and the bottom line.

Rapid change in enforcement

The typical energy company reports to 15 or more federal agencies, with state and local regulations layered on top of federal laws and statutes. Unlike in years past, when agencies were constantly forced to play catch-up to new business techniques and practices, today this vast network of regulatory bodies has access to a wide range of corporate and market data as well as the sophisticated systems needed to uncover red flags that warrant further investigation.

In addition, federal agencies are continuing to seek and obtain even more data transparency. For example, the new Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law in July 2010, gives regulators broad new oversight powers and strengthens the government's access to corporate financial data, including trading strategies, communication and records. Dodd-Frank is more than a complex law requiring some 533 rulemakings: It represents a new era in compliance for energy and commodity companies. It brings a level of regulatory oversight to Over-The-Counter trading markets for commodities that has not previously existed.

The volatility of commodity prices in the recent past has already drawn increased regulatory scrutiny of market participants and, as you might expect, is resulting in an increased number of cases being brought against corporations and their employees. The Department of Justice (DOJ), for example, finalized more than 30 deferred prosecution and non-prosecution agreements against U.S. businesses in 2010, resulting in more than $2.3 billion in penalties. That's up from just one such agreement in 2000. Now, the Securities and Exchange Commission is joining the DOJ in using non-prosecution agreements, finalizing its first-ever Non-Prosecution Agreements (NPA) with a U.S. corporation in 2010. The Commodity Futures Trading Commission (CFTC) has been more active in recent years as well, leveling more than $500 million in fines over the past three years. The regulatory provisions of Dodd/Frank could increase the scope and effectiveness of this scrutiny.

Regulatory agencies are ramping up their efforts via increased budgets and staffing, too. The DOJ's budget in 2010 represented the agency's largest ever single-year increase, with a primary focus on expanding financial fraud programs and hiring additional lawyers to pursue cases. The requested 2011 budget was even larger, up 23 percent. And the CFTC estimates it will need an additional 400 staff members to meet its increased responsibilities under Dodd-Frank.

Old views no longer apply

Though government regulators have been increasing their reach and level of activity for a decade or more, energy companies have been slow to change their thinking on compliance.

Traditionally, compliance has been considered the responsibility of individual business units, functions or geographic regions. Finance worried about financial regulations; operations about safety and environmental laws; human resources about employment standards; and so on. At many businesses, there is no overarching process for linking these compliance efforts together or ensuring that they are following the same standards and intent.

This silo approach eventually leads to everyone within the organization assigning a different meaning and value to the word "compliance," and approaching the actual activity of ensuring compliance in different, sometimes ineffective, ways.

Further complicating matters is the adversarial manner in which some companies view regulatory agencies. Energy companies that are focused on managing business risks often overlook the important role that compliance can play in identifying patterns of behavior or suspicious activities that can be harmful to the company. At many companies, the thinking is that proper compliance programs merely make it easier for regulators to catch companies doing something wrong. In their view, the company's primary focus in those instances should be on defending the company, not investigating it.

For example, compliance software can monitor patterns of behavior or misconduct and identify warning flags that make it easier for companies to dig deeply into suspicious transactions or activities. From a legal perspective, these reports could be considered discoverable evidence. Thus, the compliance strategy for many companies has been to avoid this type of scrutiny, and place the burden of proof on regulatory agencies.

But this adversarial notion of company vs. regulator is waning at many companies. The "no smoking guns" approach to compliance was developed when data was difficult to obtain and track, but regulators today can more easily determine when there are issues that require additional investigation. The increase of regulatory scope, access to data and improvement in trade surveillance software technology is likely to represent a new era for compliance oversight in the commodity markets.

And because regulators consistently tell firms that self-reporting of problems can mitigate or eliminate sanctions, the failure to discover a problem can be seen as an indication of lax oversight. As regulators gain more access to market data, the likelihood of a government agency knocking on your door to inform you of an internal problem you hadn't noticed increases.

That's why companies today must make the strongest possible effort to monitor compliance and cooperate fully with law enforcement when required. A proper compliance program, working together with risk management, will no doubt bring issues to light. No company is immune from individuals believing they are above the law, or in fact not understanding current regulations. But regulators want companies to come forward and take responsibility for transgressions proactively. An active, engaged compliance function can show a "good faith" effort to self-police.

Bottom line: it's no longer a good defense to claim ignorance on what was going on within your own organization.

Internal, external protection

At PwC, we define compliance for energy companies involved in commodities trading as the "examination of data by internal or external oversight systems to determine if the company's actions are distorting the ability of other market participants or the company to accurately view their risk in the market." We advocate ensuring that companies meet their governance objectives by requiring that compliance and risk management work together in a coordinated fashion, underpinned by well-documented and understood principles and values.

When the proper people, processes, technology and organizational structure are in place to continuously monitor the company's activities—from both an internal policy perspective and an external market perspective—there is tremendous value to the company. The risk management side protects the company from financial loss due to trades or actions that are prohibited by policy; the compliance side protects the company from external fines, legal costs and loss of reputation.

In follow-up articles, we'll explore some of the particulars of Dodd-Frank and what energy and commodity companies should be doing now to create and maintain an effective corporate-wide compliance program. But the first step is recognizing that compliance—and cooperation—should be critical elements of any company's oversight efforts.

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Mr. Lord has over 30 years experience in the energy sector in progressively senior management roles—including the utility, regulatory, trading and consulting sectors—having held positions in the business development, marketing, trading, compliance, regulatory affairs and risk control segments of the industry. His experience includes formulating strategic, financial and transactional goals; conceptualizing the financial and organizational structures and product offerings to achieve those goals; and communicating, implementing, marketing and controlling these structures as well as working to secure equity financing for the underlying assets for such strategies. His latest focus has been the strategy, process change and implementation requirements for adopting increasingly sophisticated trade surveillance monitoring infrastructure for oversight of futures, swap, and physical trading in commodity markets.

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