Title: REMIT Criminal Sanctions

IA No: DECC0164

Lead department or agency: Department of Energy and Climate Change (DECC)

Other departments or agencies: None.

Impact Assessment (IA)

Date: 20/10/2014

Stage: Final

Source of intervention: EU

Type of measure: Secondary legislation

Contact for enquiries:
arvin.jebo@decc.gsi.gov.uk
anthony.moulds@decc.gsi.gov.uk

Summary: Intervention and Options

RPC: GREEN

Cost of Preferred Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB in 2009 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
-£1.2m	-£1.2m	£0.11	No	n/a

What is the problem under consideration? Why is government intervention necessary?

EU Regulation on wholesale market integrity and transparency (REMIT) introduced new prohibitions against market manipulation and insider dealing in wholesale energy markets and imposes new requirements in relation to information provision. The Government has already legislated to create a civil enforcement regime. The civil sanctions regime does not meet all the requirements of REMIT, for example there may be cases in which the threat of civil sanctions is not sufficient to deter offending behaviours. The proposal is therefore to create new criminal sanctions in GB for the most serious instances of market abuse to establish an effective deterrent and to align penalties with the UK financial services regime, which already has criminal sanctions for market abuse. Secondary legislation is required to create the new criminal sanctions.

What are the policy objectives and the intended effects?

The policy objective is to put in place a criminal sanctions regime for energy market manipulation and insider trading in order to: ensure compliance with REMIT by having effective, dissuasive and proportionate sanctions, which reflect the gravity of the breaches and; to address difference in treatment between financial markets and energy markets and thereby remove any incentives to act improperly in energy markets compared to financial markets. Civil sanctions are not a sufficient deterrent against the full range of possible breaches; criminal sanctions are potentially more dissuasive in some important circumstances and will ensure Ofgem has the full range of effective, proportionate and dissuasive tools in order to deter wrong-doing.

What policy options have been considered, including any alternatives to regulation?

Two options were considered:

Option 0: The do nothing is a continuation of current arrangements where only civil sanctions are in place for instances of market abuse under REMIT.

Option 1: Establish new criminal offences for breaches of the most serious prohibitions in REMIT Article 3 (insider dealing) and Article 5 (market manipulation). Such offences would be created through secondary legislation under s.2 (2) of the European Communities Act 1972 – which means a maximum available prison sentence of two years for these offences.

Option 1 is the preferred option because the limited approach focussing on the offences of insider dealing and market manipulation provides the best balance of strong and effective deterrence to market abuse with no additional burdens on market participants and meets the requirements of the EU REMIT regulation without gold-plating (see the detailed discussion of the One in Two Out assessment in Section 8 below). Option 0 does not meet the policy objectives.

Will the policy be reviewed? It will be reviewed. **Review date:** 2018					
Does implementation go beyond minimum EU requirements?			**No**		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro: Yes**	**< 20: Yes**	**Small: Yes**	**Medium: Yes**	**Large: Yes**
What is the CO2 equivalent change in greenhouse gas emissions? (Million tonnes CO2 equivalent)			**Traded: n/a**	**Non-traded: n/a**	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Edward Davey Date: 20.01.2014

Summary: Analysis & Evidence

Policy Option 1

Description: Create new criminal offences around insider dealing and market manipulation in energy markets (in line with Articles 3 & 5 of REMIT) to be available to Ofgem alongside civil offences. The offences would be created using regulations and would therefore have maximum sentences of 2 years imprisonment.

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2014	Time Period Years 11	Net Benefit (Present Value (PV)) (£m)		
			Low: -26.5	**High: -0.6**	**Best Estimate:** -1.2

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	n/a	n/a	0.075	0.6
High	n/a		3.1	**26.5**
Best Estimate	**n/a**		**0.15**	**1.2**

Description and scale of key monetised costs by 'main affected groups'

The main affected groups are: Ofgem as energy market regulator, energy market participants – in particular, those with trading activities, market participants investigated for potential breaches of REMIT.

Establishing criminal offences for market manipulation and insider dealing is not expected to directly impose new burdens on lawfully operating market participants, as there are already prohibitions in place for such behaviours and Ofgem would use information already supplied under the existing REMIT regime. This is supported by responses to the consultation in which 12 out of 14 respondents indicated that they would not have to change any processes because of the proposed new criminal sanctions. In the central case, it is assumed that there are zero criminal court proceedings each year and therefore the direct cost to compliant businesses for this aspect of the regime is expected to be zero. In the central case, costs for Ofgem are expected to be around £150,000 per year, for investigation and handling of suspicious cases, but these investigations are assumed not to result in court proceeding. While Ofgem is not proposing to increase license fees to reflect the potential cost of criminal investigations or proceedings it is recognised that this annual cost, if realised, would imply an equivalent opportunity cost to industry, subject to the regulator's capacity to make efficiency savings. If criminal cases are prosecuted there would also be costs to defendants and to the criminal justice system through sentencing costs. There is a high threshold to cross before any prosecution and it is assumed that there are no prosecutions in the central case. Sensitivity analysis was also undertaken to demonstrate estimated impacts under low and high cost scenarios.

Other key non-monetised costs by 'main affected groups'

All identified costs have been monetised.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	n/a	n/a		
High	n/a			
Best Estimate	**n/a**			

Description and scale of key monetised benefits by 'main affected groups'

No benefits have been monetised, see below for non-monetised benefits.

Other key non-monetised benefits by 'main affected groups'

The main benefit to wholesale energy market participants and consumers is the deterrence effect on market abusive behaviour meaning that fewer people will lose money to unfair trading directly or indirectly through higher energy bills.

Increased market confidence from the operation of a market free from improper practices is likely to have non-quantifiable competition benefits including increased participation, more liquidity and better price formation. Respondents to the consultation were mostly in favour of the proposed new offences.

Key assumptions/sensitivities/risks 3.5

- 3.5% real discount rate, a NPV base year of 2014 and all values are expressed in 2014 real prices.
- An appraisal period of 11 years covering the period 2014-2024. Costs are assumed to commence in 2015 – the year in which the proposals are expected to be implemented - and extend for a period of 10 years to end 2024.
- Central case: It is assumed that there will be effective enforcement and that there will be no additional costs to compliant businesses. However, the assumed costs to the regulator for undertaking investigations, which are assumed not to proceed to criminal trial, are assumed to be passed-through to industry.
- Sensitivity analysis: There is uncertainty around the number and complexity of investigations that will be conducted by the regulator and consequently the costs that may transpire in the future each year. There is also uncertainty around the eventual outcome of cases, in particular whether some lead to criminal court proceedings and if so whether the legal judgement finds in favour of the regulator or defendant and associated costs of individual cases. Analysis has been undertaken on 'low' and high' cost scenarios to demonstrate a reasonable range of potential impacts.
- Assumptions of costs to the regulator for enforcement costs of the new regime, costs assumed for court proceedings and sentencing costs assumed in the sensitivity analysis**.**

BUSINESS ASSESSMENT (Option 1) (2009 Prices, 2010 NPV base year)

Direct impact on business (Equivalent Annual) £m:			**In scope of OITO?**	**Measure qualifies as**
Costs: £0.1	**Benefits:** zero	**Net:** £0.1	No	N/A

Evidence Base

1 Problem under consideration

Background to 2013 transposition of REMIT in GB

1. The EU Regulation (No 1227/2011) on integrity and transparency (REMIT), which came into force in December 2011, provides a consistent EU-wide regulatory framework specific to wholesale energy markets that:

    i. defines market abuse. This includes market manipulation, attempted market manipulation or insider trading;

    ii. explicitly prohibits market abuse;

    iii. requires effective and timely public disclosure of inside information by market participants; and

    iv. obliges firms professionally arranging transactions to report suspicious transactions.

2. REMIT therefore creates an important framework for identifying and penalising market abuse in the UK and across the rest of Europe. As a consequence, it helps energy consumers, industry and other market participants have confidence that wholesale energy prices are open, fair and competitive, the key foundations of an effectively functioning energy market.

3. Member States are required to put in place an enforcement regime that:

    i. is effective, dissuasive and proportionate;

    ii. reflects the gravity of a breach of particular REMIT prohibitions; and

    iii. is equivalent to the sanctions available for insider dealing in or the market manipulation of financial markets.

4. In June 2013, the Government created a civil enforcement regime for GB energy market abuse with similar measures being put in place in Northern Ireland in August 2013. This civil regime is not yet fully in place because implementing Articles 8 (data reporting) and 9 (registration of market participants) of REMIT is dependent on the publication of Implementing Acts at the EU level by the European Commission. However, in transposing REMIT in relation to Articles 3 and 5, under the civil enforcement regime, Ofgem as the GB national regulatory authority (NRA) has powers through The Electricity and Gas (Market Integrity and Transparency) (Enforcements etc.) Regulations 2013 to monitor, investigate and enforce against breaches of REMIT. The allows Ofgem to:

    i. oblige any regulated person to record and retain records, including relevant communications, for a period of at least 6 months from the date the record was created;

    ii. require that these records are kept for longer, until a specified date;

    iii. require those regulated under REMIT to provide information in connection with monitoring the integrity and transparency of the wholesale market;

    iv. investigate where circumstances suggest a failure to comply with REMIT. In this context, Ofgem can; require any person to provide information or documents relevant to an investigation, and summon people to attend a meeting and answer questions, and to apply for a warrant to enter premises.

5. Under the REMIT regime, trades are reported to the EU Agency for the Cooperation of Energy Regulators (ACER) and that information is available to Ofgem and the Northern Ireland Utility Regulator (NIAUR). As outlined above, market participants will have to keep records and comply with investigations. Under the current civil enforcement regime, Ofgem and the Utility Regulator can publicly censure or place unlimited financial penalties on those who break the rules on market abuse. The regulators can also demand payment for profits, or losses suffered, from non-compliance under REMIT. Under the current regime the powers to enforce civil sanctions therefore create a strong deterrent, but do not enable Ofgem or NIAUR to bring criminal proceedings. The original costs for REMIT civil sanctions were considered in a separate regulatory triage assessment in April 2013.

Proposed strengthening of the REMIT sanction regime in the UK

6. In the Annual Energy Statement of October 2013[1], the Government stated that it aimed to introduce strong sanctions against those who manipulate energy markets and that it intended to consult on the introduction of criminal penalties, such as those already in place in financial markets, for such actions. Although cases of market abuse are likely to be rare, their impact on the functioning of energy markets could be significant, including detrimental impacts on market participant and consumer confidence.

7. In August 2014, the Government launched a consultation on the proposal to create new criminal offences for energy market manipulation and insider trading on energy markets. The proposed criminal offences are intended to support the existing civil enforcement regime, which while creating a strong deterrent are not considered to go far enough in penalising the most serious potential market abuse offences. In addition, given that the prohibitions in REMIT against insider trading and energy market manipulation closely resemble the criminal offences that already exist in the UK in relation to equivalent conduct in the financial markets, the Government considers that similar sanctions should also be available for energy markets.

8. There were 14 responses from the energy industry and related businesses to the consultation and 30 organisations attended a stakeholder event. A summary is attached at Annex C. The key points emerging from the consultation were that:

    - most respondents supported the creation of criminal sanctions for energy market manipulation and insider dealing;
    - no respondents indicated that the proposed offences would create extra regulatory burdens;
    - most respondents did not believe there would be benefits such as increased market confidence as a result of the proposed criminal offences;
    - there were a range of issues on which respondents indicated they would value clarification or guidance which are summarised in Annex C and discussed in the Risks section below; and
    - most respondents thought that the offences set out in the consultation were framed in the correct way and agreed that there should be a requirement for intentional or reckless behaviour.

[1] DECC, Annual Energy Statement, October 2013
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/254250/FINAL_PDF_of_AES_2013_-_accessible_version.pdf

2 Policy Objectives

9. The policy objective is to put in place a criminal sanctions regime for energy market manipulation and insider trading in order to:

    - ensure market participant compliance with REMIT by having effective, dissuasive and proportionate sanctions that reflect the gravity of particular breaches of REMIT available to Ofgem; and

    - address the difference in treatment between financial markets (where criminal sanctions are already in place for equivalent offences) and wholesale energy markets, and remove any incentives to act improperly in energy markets compared to financial markets.

3 Rationale for government intervention

10. The rationale for government intervention in the form of legislation to create offences for market abuse stems from the benefits associated with transparent and well-functioning wholesale trading arrangements. Wholesale energy markets provide key price signals which affect the choices of producers and consumers, as well as investment decisions in production facilities and transmission and distribution infrastructure. As a consequence, it is essential that these price signals reflect fair and competitive interaction between supply and demand conditions and that no profits (economic rent) can be extracted from market manipulation or insider trading.

11. Greater transparency in wholesale energy markets therefore reduces the risk that markets are manipulated and that price signals are distorted. As a result, it is crucial in ensuring that consumers (households and businesses) pay a fair price for gas and electricity via the retail energy market. Moreover, it helps create a level playing field for all market participants.

12. As outlined in paragraph 7 above, while the civil sanctions regime provides a strong deterrent to market abuse, it is considered that full implementation of REMIT regulations in GB should see the existing enforcement arrangements supported by the introduction of criminal sanctions. There are three key reasons for adding criminal offences to the REMIT civil enforcement arrangements for energy market manipulation and insider dealing:

    a. the need for alignment with financial market regime;

    b. the additional dissuasive effect - some market participants may not be dissuaded by civil sanctions alone; and

    c. the most serious breaches can lead to significant harm and therefore very strong sanctions are required as a proportionate deterrent.

13. As outlined in the consultation document, due to the potentially significant detrimental economic impacts that could arise as a result of insider dealing and market manipulation, the creation of criminal sanctions is considered a proportionate regulatory response for the most serious instances of market abuse.

14. Wholesale energy markets can be regarded as lacking transparency, as they are operated by highly skilled organisations operating with commercially confidential information, coupled with individuals trading highly technical financial instruments and contracts. This combined with the huge

significance of energy for the economy and consumers and the very large sums of money involved, means that, though the risk of wrong-doing is small, its impact could be great.[2] Estimating the benefits of reducing illegal activities such as market abuse is challenging. However, evidence from the UK financial services sector, although not conclusive, suggests that the introduction of criminal sanctions for market abuse may have reduced the level of abnormal price movements ahead of regulatory takeover announcements and acted as a deterrent against insider trading.[3]/[4]

15. The scope for instances of market abuse – particularly if they involved large traded volumes of gas or electricity – to have materially detrimental impacts on the functioning of energy markets is demonstrated by the cumulative value of trades. In 2013, the value of trades in the GB wholesale energy market was estimated at between £299-£334 billion. The notional value of trades in the gas and power markets for the period February 2013 to January 2014 were around £255 billion and £41.5 billion respectively.[5] In addition to the value of GB trades, a significant volume of European energy products are traded through London based brokers. However, a proportion of these trades take place on market places regulated by the Financial Conduct Authority (FCA) - the UK financial services regulator – which has power to pursue civil or criminal sanctions in cases of market abuse and inside information.

16. As outlined above, wholesale market abuse is likely to lead to price signals that do not reflect fair and competitive interplay between supply and demand. Repeat instances of such abuse would be likely to undermine the confidence that market participants place in the proper functioning of the market. In energy trading, this may reduce the volume and value of transactions which would reduce the level of liquidity on trading platforms. In addition, market abuse may undermine confidence or distort price signals in the market to the extent that it detrimentally affects investment and ultimately competition in the energy generation, supply and distribution sectors. Moreover, serious or repeated instances of market manipulation or insider trading could lead to market exit by some participants and/or deter new market entry. Further potential consequences if distorted price signals create disincentives for investment in physical infrastructure include risks to short-term and long-term security of supply in energy markets.

17. Wholesale energy market prices are also important because they form a key component of retail prices eventually faced by household and industrial consumers with associated cost of living and business competitiveness implications. It is also important for market participants, consumers, and the Government to have confidence and trust in the integrity of wholesale energy markets as this is a prerequisite for competitiveness and confident investment decisions by market participants. Responses to the consultation did not however suggest that there would be significant positive impacts on market confidence among market participants.

18. The majority of stakeholders responding to the consultation agreed that the Government should create the proposed offences. A small number felt that the proposed offences are unnecessary because the civil regime will be sufficiently effective. Respondents to the consultation did not identify specific behaviours that breached REMIT but two indicated that there had been occasions on which they had had concerns about market behaviours.

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[2] A joint investigation between Ofgem and the FCA into alleged gas market manipulation in 2012 reflected the seriousness of such actions- https://www.gov.uk/government/news/edward-daveys-response-to-conclusion-of-investigation-in-to-alleged-uk-gas-market-manipulation

[3] This market estimate is for the market from February 2013 until January 2014. Estimates calculated based on the data published by LEBA with the average of the month-ahead ICE NBP price.

[4] http://www.fca.org.uk/your-fca/documents/annual-report/fsa-annual-report-201213-section-3-delivering-market-confidence and page 58 of European commission staff paper on criminal sanctions for insider dealing and market manipulation- http://ec.europa.eu/internal_market/securities/docs/abuse/SEC_2011_1217_en.pdf

[5] Actual brokered over the counter energy data was used (Source: London Energy Brokers Association), APX and N2EX auction data for 2013, plus the additional estimated proportion of that market that is not OTC (Source: Trayport Euro Commodities Market Dynamics Report 2013). Estimates calculated based LEBA's data, using simple averages of the daily prices for baseload month ahead ICE NBP price

Distortion arising from the existence of criminal sanctions for insider trading in, or manipulation of, some energy-related markets or products but not others

19. Alignment with financial services regulation is a key priority because, while there are products that are clearly physical energy products or are clearly financial products, there is a significant amount of trading in products that can come under REMIT or financial regulation depending on the platform on which they are traded. Roughly 30% of gas volumes and 3% of electricity volumes take place on markets regulated by the FCA. Articles 3 and 5 of REMIT do not apply to all wholesale energy products because some of them are treated by regulations as financial instruments. In view of the fact that prohibitions in REMIT closely resemble the existing criminal offences for equivalent conduct in financial markets, there is a risk that a difference in the penalties available for insider trading or market manipulation creates incentives that direct market abuse towards the energy sector. Of the respondents to the consultation, 10 out of the 14 agreed that alignment with financial services is important.

20. The FCA has the power to bring enforcement action (both civil and criminal) against traders who breach the regulation on energy derivatives in a regulated market. However if a similar energy derivative was traded on a platform that comes under the REMIT regulation, Ofgem can currently only seek civil sanctions. This lack of criminal sanctions in energy markets for almost identical misbehaviours to those that could receive a criminal sentence in financial markets creates a risk that wrong-doing is directed towards the energy sector. The offences being proposed for the wholesale energy market have therefore been designed to closely align with the UK financial regime context and the two regulators work closely together.

Criminal sanctions create important additional deterrent effects including for individuals who would be less influenced by civil sanctions.

21. The civil sanctions regime with significant potential penalties are likely to dissuade wrong-doing and influence sound oversight practices in organisations that expect to trade regularly or have funds that could be targeted by fines.

22. Criminal sanctions are likely to be more dissuasive of wrong-doing where:

- the market participant is not likely to be a repeat player, for example someone with one-off information about an energy infrastructure problem;
- a criminal conviction has a particular additional impact on the ability of a person or organisation to conduct business, for example in terms of participation in certain markets or reputational damage from a criminal record; and/or where;
- financial incentives are not sufficient. For example, a person or organisation that is already in financial difficulties and believes that they have little money or little anticipation of future legitimate earnings to lose. Some individuals and businesses may not be deterred by even unlimited fines. They may have limited funds that could be targeted or may assess that the potential exposure is worth the potential gain. This is likely to be particularly true where individuals are committing offences such as insider dealing, perhaps in collusion with others, and where their employer is not complicit.

23. In UK financial markets, criminal sanctions are considered by the regulator to have a stronger deterrent effect for market abuse than that of administrative sanctions alone[6]. Evidence from competition regulation[7] also indicates that criminal sanctions have a stronger effect regarding deterrence compared to financial and other penalties, and businesses view criminal penalties as the strongest motivator for compliance compared to other types of penalties. It states that "*companies' average ranking of the factors which motivate compliance was: (1) criminal penalties (2) disqualification of directors (3) adverse publicity (4) fines and (5) private damages actions*." [8]

24. In addition, criminal sanctions that can be applied to offences committed by individuals can help address principal-agent problems in which companies (shareholders) can find themselves liable for significant financial penalties for wrong-doing committed by traders or others in key operational roles. The availability of criminal sanctions can act as an additional deterrence or disincentive to breaching market, and organisational, rules and therefore better target sanctions at those found guilty of offences.

4 Description of options considered

25. For the purposes of this final stage Impact Assessment two main policy options have been considered:

    i. **Option 0**: The baseline, 'do nothing' option;

    ii. **Option 1**: Introduce criminal sanctions for Article 3 (inside information) and Article 5 (market manipulation)

26. The consultation stage Impact Assessment of August 2014 also considered a third option (Option 2) which has now been ruled out from further consideration. In addition to the central prohibitions in articles 3 and 5, REMIT sets out a range of requirements on market participants (Annex A provides a summary of all prohibitions under REMIT), for example around registration with Ofgem and the reporting of data:

    i. *Article 8: Data reporting:* Market participants (or persons listed on their behalf) are required to provide the Agency with a record of wholesale energy market transactions, including the orders to trade. This includes the precise identification of the product; price and quantity agreed and dates and times of execution.

    ii. *Article 9: Registration of market participants:* Market participants who are required to report to the agency (in accordance with article 8) will need to register with Ofgem.

27. Ofgem already operates a licensing regime under the Electricity Act 1989 and the Gas Act 1986. Under this regime, it is a criminal offence to carry out activities without being licensed, whereas subsequent contraventions (such as breaching the Standard Licence Conditions) only incur civil sanctions.

28. Option 2 would also have made it a criminal offence to enter into transactions in wholesale energy products without being registered and to fail to provide the required information to Ofgem. Most

[6] In a speech to the Financial Service Authority (FSA, predecessor to the FCA) Enforcement Conference on 18 June 2008, the UK FSA Director of Enforcement Margaret Cole said: "We feel that the threat of civil fines hasn't worked as well as we would have liked. We're convinced that the threat of a custodial sentence is a much more significant deterrent. The good news is that in this area stakeholders and commentators all seem to agree with us."
http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0618_mc.shtml
[7] "An assessment of discretionary penalties regimes" Office of Fair Trading, October 2009: http://londoneconomics.co.uk/wp-content/uploads/2011/09/30-An-assessment-of-the-UK-Discretionary-Penalties-Regime.pdf
[8] Ibid. (p24)

respondents to the consultation agreed with the proposal not to create criminal offences for these wider REMIT requirements and the Government will not be pursuing this option.

Alternatives to regulation

29. The alternative to regulation for criminal sanctions is relying on existing civil sanctions and on the wider criminal law as it applies to trading. There are some instances where those offending are unlikely to be deterred by civil sanctions, for example, those who do not feel they have much to lose from civil penalties. It is not always possible to apply wider criminal law on, for example, fraud to market abusive behaviours.

30. Specific prohibitions are likely to lead to better compliance regimes (because businesses are clear as to what behaviour they need to guard against) and clarity for the regulatory authorities as to whether prohibitions have been breached. Voluntary measures such as companies' own internal cultures and procedures that are important in preventing market abuse are unlikely to provide sufficient safeguards by themselves and are strengthened by having effective legal sanctions in place.

Option 0 – Do nothing (base case option in which no criminal sanctions for REMIT are implemented)

31. This option reflects the baseline, business as usual case where there is no further government intervention in the arrangements for preventing market abuse in wholesale energy markets. Under this scenario energy markets would be subject to a civil sanctions regime for REMIT as enforced by Ofgem.

32. Under this arrangement, Ofgem has the ability to request relevant information; carry out onsite inspections; and impose unlimited fines or require restitution for breaches of the REMIT prohibitions on insider dealing and market abuse and the requirement to publish inside information. Market participants would also continue to need to act within the wider criminal and civil law, for example on fraud and anti-competitive practices. Please see annexes A and B for a description of the REMIT civil sanctions regime and other relevant regulations.

33. While these powers create a strong deterrent for most market participants, they do not enable Ofgem to bring criminal proceedings specifically for insider dealing and market manipulation. As noted above there is a case for ensuring the strongest sanctions for the most serious offences, that address the current inconsistency with financial services offences and target the full scope of possible unlawful behaviour.

Option 1: Criminal sanctions for Article 3 (inside information) and Article 5 (market manipulation)

34. This option would create, in addition to the existing civil and criminal law set out in Option 0, new criminal sanctions for the most serious offences under REMIT - which are insider trading (Article 3) and market manipulation (Article 5). These activities may have serious financial impacts on market participants and on the wider confidence in the operation of gas and power markets by distorting prices, competition and deterring market entry.

    i. *Article 3: Persons who possess inside information in relation to a wholesale energy product are prohibited from buying or selling relevant energy products or disclosing the information or making someone else buy or sell the products*

    ii. *Article 5: Market manipulation can be broadly defined as any deliberate attempt to interfere with the fair and open operation of a market to artificially change the market price, or the appearance of the price, of a security, commodity or currency*

35. Criminal sanctions around only these central prohibitions of REMIT would result in proportionate implementation and would closely align the energy markets with financial market trading. In order to ensure these offences and the benefits are in place as quickly as possible it is proposed that secondary regulations would be created through section 2(2) of the European Communities Act

1972[9]. This would enable Government to create criminal sanctions of up to two years imprisonment for insider dealing in or manipulation of energy markets.

36. Creating new criminal sanctions for REMIT will not place additional compliance burdens on business because registration, monitoring, and investigatory powers have already been established through regulations made in June 2013. Criminal sanctions for Articles 3 and 5 of REMIT are appropriate to meet UK obligations under the regulation and do not go further than its requirements. Further discussion of this issue is included in the OITO section below.

5 Monetised and Non-Monetised Cost and Benefits

37. This section identifies and analyses the costs and benefits of the proposed options for implementing REMIT criminal sanctions, and then compares these options on the basis of benefits relative to costs.

Option 0: Do nothing (business as usual in which no criminal sanctions regime is implemented)

38. By definition, under the baseline 'do nothing' option, there would be no change to the current arrangements for preventing market abuse and therefore energy markets would continue to be subject only to the civil sanctions regime as enforced by the regulator. As a consequence there are no costs or benefits associated with maintaining the status quo.

Option 1: Criminal sanctions for breaches of Article 3 (inside information) and Article 5 (market manipulation)

39. In estimating the costs and benefits of the policy proposal, a 'central case' is presented which is considered a reasonable view of the potential impacts. This is supported by sensitivity analysis on the potential costs to reflect the inherent uncertainty around the number, complexity, unit costs and eventual outcome of criminal proceedings in the future which is presented under as a 'low cost scenario' and a 'high cost scenario'. In all cases it has only been possible to quantify the expected costs of the policy. While benefits are expected as a result of creating a criminal sanctions regime, these are described qualitatively.

CENTRAL CASE

Costs to the Regulator

40. Market participants being monitored or investigated by Ofgem will be subject to the same requirements and requests under the regime with criminal sanctions as they are currently under the purely civil regime. It is however anticipated that there will be additional on-going costs to Ofgem in implementing a new criminal sanctions regime over and above those created by the existing civil regime. These costs would be incurred by undertaking more detailed investigations of suspicious transactions up to a sufficient standard of evidence as required for criminal court cases. Ofgem already has criminal enforcement powers in other areas aside from those covered by REMIT, so the additional cost from introducing new criminal enforcement powers for REMIT is likely to be a proportion of the cost to Ofgem of ensuring it has the appropriate skills and equipment needed to conduct criminal investigations across all its criminal sanction powers.

41. The decision as to whether a case should be prosecuted or dealt with through the civil sanctions regime or other enforcement route (such as fine for a breach of licence condition) is likely to be made by Ofgem some way into an investigation. It is not expected that the investigation process in itself would automatically increase costs for Ofgem or business with the exception of any additional

[9] Section 2:2 of the European Communities Act 1972- http://www.legislation.gov.uk/ukpga/1972/68/contents

requirements for Ofgem in terms of handling evidence. Under criminal investigations, cases would require a high level of specialist input to handle trade and other data, potentially obtained from hard-drives, and other electronic equipment, compiled and presented to the robust standard required for criminal court proceedings.

42. Ofgem have estimated the cost of collecting this more detailed and robust information to be £75,000 on average per criminal investigation undertaken, based on quotes they have received in this area. Under the central case, it is assumed that Ofgem would undertake two criminal investigations per year over the period 2015-2024, equating to a total of £150,000 (2014 prices) per year in additional costs relative to the current arrangements. However, it is further assumed that these cases are not taken do not result in criminal court proceedings[10] and consequently there are no other recurring costs to Ofgem aside from those related to conducting investigations. This assumption is discussed and tested in the sensitivity analysis section below where the cost implications associated with the potential for investigations to result in prosecutions are further explored. Ofgem is not proposing to increase license fees to reflect the potential cost of criminal investigations or proceedings, but instead intends to absorb these costs within planned administrative budgets. However, it is recognised that this annual cost, if realised, would imply an equivalent opportunity cost to industry of £150,000 per year, subject to the regulator's capacity to make efficiency savings.

43. There are not expected to be any additional transition costs to Ofgem. This is because REMIT enforcement for Articles 3 and 5 is covered by the civil sanctions regime and the only additional costs are for the increased requirements in terms of specialist input and development of the standard of evidence required for criminal proceeding which will be incurred on a per criminal investigation basis.

44. The present value of these costs discounted at 3.5% is approximately **£1.2 million** (2014 prices). As outlined in the next section, this cost is effectively assumed to be passed through to business due to the implicit opportunity cost, subject to any offsetting efficiency savings realised by Ofgem over the appraisal period.

Costs to businesses

45. As outlined in the previous section on the costs to the Regulator, under the central case, it is assumed that there are zero criminal court proceedings each year and therefore the direct cost to compliant businesses for this aspect of the regime is expected to be zero. The creation of criminal offences for insider dealing and market manipulation should therefore, in itself, not create new direct costs for compliant businesses. This view was verified by industry in the responses to the consultation. This is because under a criminal enforcement regime for Articles 3 and 5 of REMIT there would be no additional obligations for businesses compared to those that already exist under civil sanctions regime i.e. the baseline, status-quo arrangements (Option 0). In addition, the policy proposal will not change requirements around the provision of information by industry relative to the current arrangements.

46. The majority of respondents (10 out of the 14) did not envisage any changes to their internal processes or foresee any additional costs as a result of the new criminal offences. The other respondents suggested there may be potential additional compliance and staff costs but did not say what they would be.

[10] This is a simplifying assumption, consistent with 2.3.47 of the Better Regulation Framework Manual, which states "When planning to introduce a regulatory measure, costs and benefits should assume 100% compliance, unless there is evidence of the contrary. However, differing levels of compliance should also be investigated through sensitivity analysis." Differing levels of court cases and prosecutions are explored in the risks and sensitivities of costs and benefits section.

47. It is possible that wholesale market participants[11] may choose to undertake changes or improvements to their compliance and reporting processes due to the stronger enforcement regime. If businesses chose to make such changes it would result in indirect costs as behaviour change would be required, rather than businesses being obligated to alter their current practices in order to be compliant with REMIT. The possible indirect cost implications of such behavioural changes are discussed in the risks and sensitivities section below.

48. The implementation of civil sanctions and the accompanying regulatory regime for REMIT was not intended to impose any significant additional costs on market participants.[12] To the extent that there remain a number of market participants that are non-compliant with the current arrangements, those businesses may be incentivised to improve compliance as a result of the introduction of criminal sanctions. As these costs would have been accounted for in the initial assessment of the REMIT arrangements and the creation of the civil sanctions regime, they should not be considered as direct incremental costs to business from the creation of a criminal enforcement regime.

49. As outlined in the preceding section, Ofgem is not proposing to increase license fees to reflect the potential cost of criminal investigations or proceedings which is estimated at £150,000 per year. Instead Ofgem intends to absorb these costs within existing administrative budgets. However, it is recognised that the estimated annual cost to Ofgem of £150,000, if realised, would imply an equivalent opportunity cost to industry, subject to the regulator's capacity to make efficiency savings. This cost is effectively assumed to be passed through to business due to the implicit opportunity cost, subject to any offsetting efficiency savings over the period by Ofgem, which in NPV terms is approximately **£1.2 million** (2014 prices).

50. Any business that is taken to trial, but subsequently acquitted is likely to have to meet costs and may also suffer non-quantifiable reputational damage. It should be noted that the threshold for prosecution is high and that the FSA has a high success rate when prosecuting the same offences in financial markets, but there remains the possibility, considered in the risks and sensitivities section that a small number of prosecutions will not succeed.

Benefits to businesses

51. As explained in paragraph 39 above, it has not been possible to quantify the potential benefits from the policy proposal. However, the proposed criminal enforcement regime could bring benefits to both businesses which are market participants and to those that are consumers of energy. A respondent to the consultation believed that consumers might feel greater confidence but most respondents did not think that criminal offences would increase market participants' confidence.

52. The possibility of non-compliance raises risks associated with operating in the energy market as market participants might not have confidence in wholesale price signals. Although most respondents (market participants) to the consultation did not indicate the likelihood of increased confidence as a result of the proposal, criminal sanctions for market abuse could in theory increase confidence in the proper functioning of the market in that prices reflect demand and supply fundamentals rather than distortions arising from market manipulation.

53. Reduced instances of market abuse, increased confidence and lower price volatility may also reduce transaction costs in the trading markets, raising incentives to enter and trade more extensively. A higher number of market participants and lower transaction costs would then be expected to have a positive effect on liquidity. The removal of insider trading – which generally benefits the inside trader at the expense of other traders – would also place all traders on a level playing field in terms of information and the distributional effects of trades.

[11] Wholesale energy participants include: power exchanges; energy traders/suppliers/brokers, electricity generators.
[12] Civil sanctions implementation main aim was to establish an effective, proportionate and dissuasive penalty and enforcement regime for Ofgem.

The 2012/13 Financial Services Authority annual report[13] (FSA – the predecessor regulator to the FCA) states that; "*after remaining stable for the four years to 2009, the level of abnormal pre-announcement price movements[14] declined to 21.2% in 2010, 19.8% in 2011 and to 14.9% in 2012. This is the lowest level since 2003. The fall took place in a year of weak takeover activity and against a backdrop of the FSA's continuing focus on market abuse and enforcement activity in this area*". Whilst this is not conclusive evidence regarding the deterrence effect of criminal enforcement for market abuse, it suggests that such regulatory measures may be effective in deterring abnormal price volatility in markets.

Benefits to government

54. The existence of "regulatory arbitrage" – trading on a market with less stringent regulation to avoid the stricter regime - potentially imposes costs for government in terms of additional monitoring requirements, duplication between agencies regarding enforcement, and unnecessary expenditure to cover gaps in regulation between energy and financial markets. Thus removing this is likely to offer a benefit to government regarding efficiency and effectiveness of regulation and avoidance of expenditure. This would lead to more efficient outcomes overall as differences in regulatory treatment will not influence trading decisions or commercial choices.

Benefits to consumers

55. The direct costs of insider trading and market manipulation are difficult to ascribe to any one group because they are likely to vary on a case by case basis. Therefore no attempt is made in this Impact Assessment to quantify the direct benefits of a reduction in the prevalence of market abuse and/or insider trading. However in all cases there are likely to be losers as a result of insider trading and market abuse.

56. In addition to any direct beneficiaries of reduced insider trading and market abuse, consumers could benefit indirectly from the increased deterrence of market abuse resulting from creating criminal sanctions. Increased market transparency and reduced frequency of market abuse could result in lower wholesale energy prices relative to the base case (see section above under benefits to businesses) which could then be passed through to lower retail energy prices for consumers.

57. More cost reflective prices, associated reduced barriers to investment, reduced costs of trading and resulting improved competition could also reduce costs to end users relative to the base case with associated positive cost of living and business competitiveness implications, benefiting households and commercial energy consumers.

58. According to Ofgem data[15], wholesale energy market costs account for over 46% of a typical UK consumer's energy bill. Therefore, as a purely illustrative example in terms of quantifying the benefit of lower prices more generally, a 1% reduction in wholesale energy prices which then reduces bills by 1% from the effect of criminal sanctions could save UK households over £160 million per year This indicative estimate is for illustrative purposes only and is therefore not included in the headline net present value estimate presented in this Impact Assessment due to the uncertainty and lack of evidence over the degree to which this measure would reduce wholesale prices. Table 1 below outlines the components of that calculation.

[13]Financial Services Authority Annual Report 2012/13, Section 3 "Delivering Market Confidence", http://www.fca.org.uk/news/firms/fsa-annual-report-2012-13

[14] As part of its market monitoring activity, the FSA analysed the scale of share price movements in the two days ahead of regulatory takeover announcements and identified movements that are abnormal compared to a stock's normal movement. However, it is important to note that the level of such abnormal pre-announcement price movements (APPMs) does not provide a precise measure of the level of suspected insider dealing.

[15] "Understanding Energy Bills", Ofgem 2013, https://www.ofgem.gov.uk/information-consumers/domestic-consumers/understanding-energy-bills

Table 1: Assumptions and calculations for consumer benefits (illustrative only)

Wholesale costs as a proportion of UK duel fuel bill	46%
Reduction in wholesale energy prices	1%
Reduction in household bills	1%
Cost of a typical duel fuel bill per UK household (£)	£1,357
Reduction on a typical duel fuel bill (£)	£6.24
Number of UK households (m)	26.4[16]
Bill reduction for all UK households (£m)	£164.79

Sensitivity analysis on costs

59. Under the central case, the policy proposal is expected to result in an additional cost to the regulator of **£1.2 million** (NPV, 2014 prices). As Ofgem do not intend to increase the amount recovered from industry to reflect this cost, it is assumed that there is an equivalent cost to business (i.e. pass-through of costs) due to the implicit opportunity cost associated with undertaking additional investigations. . The key driver of these cost estimates is the assumption that there are two investigations by the regulator per annum over the appraisal period, but that none of these investigations result in criminal court proceedings under the new enforcement regime.

60. However, as outlined above there is inherent uncertainty around the number of investigations that will be conducted by Ofgem as part of criminal enforcement, the complexity and therefore cost of those investigations. There is also uncertainty around the eventual outcome of cases, in particular whether some lead to criminal court proceeding and if so whether the legal judgement finds in favour of Ofgem or the defendant.

61. It is anticipated that under the central scenario businesses face no additional direct costs because their reporting requirements and the associated costs would not change under REMIT criminal sanctions, relative to that required under the current civil sanction regime. This view was supported and verified by responses to the consultation. There remains a possibility that some businesses may decide to improve their compliance procedures in light of the stronger sanctions which would result in an indirect cost to business. This may be implemented by individual companies in a variety of ways, for example by improving the robustness of procedures and processes, acquiring improved electronic systems, increased costs of legal advisory services, or training staff to improve familiarisation with REMIT. Due to uncertainty over exactly which additional improvements might be required and on what scale (i.e. the number of business electing to implement such changes, the scope, and cost of such changes), it is difficult to quantify the potential increased indirect costs to businesses. The consultation therefore raised this issue and sought feedback from business. No business identified any additional change that would be required relative to current practices or therefore the likelihood that they would incur any additional indirect costs as a result.

Low cost scenario

[16] Based on 26.4 million households, from ONS Statistical Release "Families and Households, 2013) http://www.ons.gov.uk/ons/dcp171778_332633.pdf

62. The low cost scenario reflects the possibility that there could be fewer criminal investigations than assumed under the central case for each year of the appraisal period. As detailed in previous sections, the central assumption was that there would be two investigations per year under Option 1, resulting in a total cost over the appraisal period of **£1.2 million** (NPV, 2014 prices).

63. Under the low cost scenario, it is assumed that there will be one investigation per year over the appraisal period, which is considered a reasonable lower bound assumption. Assuming the same unit cost of data handling and other investigative resources per case as in the central case, this equates to an additional cost to the energy regulator of £75,000 per year and a total cost of around **£624,000** (NPV, 2014 prices) over the appraisal period. As Ofgem do not intend to increase the amount recovered from industry, it is assumed that there is an equivalent cost to business (i.e. pass-through of costs) due to the implicit opportunity cost associated with undertaking additional investigations, subject to any offsetting efficiency savings realised by the Regulator. As in the central case, the low cost scenario assumes that in all years, no investigations result in criminal court proceedings.

High cost scenarios

64. As outlined previously, in the central scenario it is assumed that no criminal cases would be brought to court and consequently there are no costs to the criminal justice system from sentencing or additional costs to Ofgem for court cases. .

65. There is considerable uncertainty over how many breaches of REMIT would take place or how many would eventually lead to court cases and convictions, so there is resulting uncertainty over cost impacts. Costs may therefore be greater than estimated in the central case.

66. To construct a high cost scenario, information was sourced from Ofgem on expectations of costs under civil and criminal REMIT enforcement regimes. In addition, information from the FCA on past financial markets cases was used alongside published data from the National Offender Management Service (NOMS) on prison costs. This information provided the basis for a reasonable set of unit cost assumptions which enabled overall cost estimates to be produced based on scenarios of partial compliance and for a variable number of investigations and proceedings per annum.

67. Information sourced from recent successful FCA prosecutions for insider dealing indicates a total of around £1.2 million was claimed in costs from those prosecuted across eight court cases. This implies, approximately, costs to Ofgem of using counsel of around £100,000 per case, once other costs claims are deducted. Consistent with the assumption in the central case, Ofgem estimates the additional costs of data handling requirements per REMIT criminal case to be £75,000.

68. FCA information on past financial market abuse court cases indicate that around 90% of cases result in successful prosecution. The average number of individuals pursued per case was between one and two. As a simplifying assumption, the analysis below assumes that each case that is brought to trial each year results in prosecution.

69. Published data from the Ministry of Justice and NOMS[17] on the costs of prison places from their annual report and accounts for 2012-13 indicates that the average cost of providing a prison place for that period was £36,808[18]. This has be uprated to £38,140 in 2014 prices for the purposes of the IA analysis.

[17] Costs per place and costs per prisoner - National Offender Management Service
Annual Report and Accounts 2012-13 - Management Information Addendum, October 2013, Ministry of Justice
[18] Cost per place is the average cost of providing a prison place for the year. It is the direct resource expenditure or overall resource expenditure divided by Baseline Certified Normal Accommodation.

70. This information allows assumptions regarding the frequency of investigations and court cases, costs to Ofgem from investigations and counsel, and sentencing costs to be formed, as shown in Table 2 below:

Table 2: Assumptions used to estimate costs with one criminal trial a year assumed.

No. of criminal investigations a year	Average no. of cases brought to trial per year	Average counsel costs per trial (£)	Average no. of successful cases per year	Average no. of individuals per case	Average sentence length (years)	Prison costs per place per year (£)
2	1	100,000	1	1.5	2	38,140

71. Based on these assumptions, an indicative estimate for the additional total annual cost to Ofgem and the prison system is £364,419 (2014 prices). This is based on Ofgem incurring annual case handling and investigation costs of £150,000[19], counsel costs of £100,000 per year, and prison costs of £114,419 per year. The present value of these costs, discounted at 3.5% is around **£3.0 million (NPV, 2014 prices).** As Ofgem do not intend to increase the amount recovered from industry, it is assumed that the cost of investigations is effectively a cost to business (i.e. pass-through of costs) due to the implicit opportunity cost associated with undertaking this work. As in the central case, the implied cost to industry is therefore £1.2 million (NPV, 2014 prices) subject to any offsetting efficiency savings realised by the Regulator. It is assumed that the costs of legal counsel for cases taken to trial and for resulting prison places are not recovered from business, but are instead funded centrally by government in the event that they are incurred. In net present value terms, these costs are estimated at £1.8 million (2014 prices).

72. The potential costs to Ofgem could be higher or lower than presented above due to variability in practice of several factors including; the number of cases investigated, investigation costs, numbers of court cases and costs of counsel per case. The costs to the criminal justice system outlined above could be lower or higher depending on the number of convictions, lengths of sentences, prison places costs, and the number of individuals tried and sentenced per case.

73. For example, Table 3 below sets out what is considered to be a high-end yet possible scenario based on increasing the initial key assumptions on the number of investigations and cases brought to trial, the costs of legal counsel, the number of successful cases, and average number of individuals sentenced per case. In addition, it is also assumed that acquitted parties claim an additional £100,000 on average per successfully defended case for additional non-legal expenses. This is a simplifying assumption as there is considerable uncertainty over the magnitudes involved and whether or not these would be claimed for in actual criminal cases that may arise. The scenario shows an indicative profile on the assumed number of investigations, trials and successful outcomes, each of which are assumed to gradually reduce in number over the appraisal period. The declining profile is considered reasonable as we may expect increased compliance over time as the new sanction regime is expected to act as a deterrent to instances of market abuse. It is also broadly in line with the trend witnessed in financial markets between 2009-2012, where a fall in the level of abnormal pre-announcement price movements followed the FSA's continuing focus on market abuse and enforcement activity in this area. As noted in paragraph 53, whilst this is not conclusive evidence on the deterrence effect of criminal sanctions for market abuse, it does suggest that regulatory measures may be effective in deterring abnormal price movements in markets.

[19] £75,000 handling and investigation costs per case, for two cases investigated per year.

Table 3: Assumptions used to estimate costs with, five investigations undertaken, and four criminal trials assumed a year with higher counsel costs and sentences.

Time Period	No. of criminal investigations a year	Average no. of cases brought to trial per year	Average counsel costs per trial (£)	Average no. of successful cases per year	Additional costs claimed per unsuccess-ful case (£)	Average no. of individuals per case	Average sentence length (years)	Prison costs per place per year (£)
2015-2019	5	4	500,000	2	100,000	3	2	38,140
2020-2021	4	3		2				
2022-2023	3	2		1				
2024	2	1		1				

74. Based on these assumptions, an indicative estimate for the additional total annual cost to Ofgem and the prison system is around £4.0 million per annum (2014 prices) in years 2015-2019 inclusive before tapering down to an annual cost of around £880,000 in 2024. In net present value terms (discounted at 3.5%) this equates to total costs of **£26.5 million (2014 prices)**. It is this figure that is used as the high estimate for the purposes of this Impact Assessment, as reported in the summary sheets. As Ofgem do not intend to increase the amount recovered from industry, it is assumed that the cost of investigations is effectively a cost to business (i.e. pass-through of costs) due to the implicit opportunity cost associated with undertaking this work. The implied cost to industry is therefore £2.6 million (NPV, 2014 prices), subject to any offsetting efficiency savings realised by the Regulator. It is assumed that the costs of legal counsel for cases taken to trial, reimbursement of costs for acquitted trials, and for prison places are not recovered from business, but are instead funded centrally by government in the event that they are incurred. In net present value terms, these costs are estimated at £23.9 million (2014 prices).

Sensitivity analysis of benefits

75. As outlined above under Option 1, there are potentially benefits to business, government and customers as a result of reducing the likelihood of any market abuse or insider trading, through the disincentive effect created by a criminal sanctions regime. However, it is possible that these will be realised to a greater or lesser degree. As these benefits were not quantified in the central scenario no sensitivity analysis has been undertaken around the potential magnitude of the impacts.

Summary of Monetised Estimates

76. Table 4 below summarises the estimated costs of the policy proposal in the low, central and high cases in Net Present Value terms (2014, prices). As explained previously, it has not been possible to monetise any of the benefits that could be expected to result from the proposal, but these have been described in qualitative terms above. Under the central case, the policy is therefore estimated to have a net societal level cost of **£1.2 million** (NPV, 2014 prices) over the appraisal period.

Table 4: Summary of costs in low, central and high cases, £m NPV, 2014 prices (2014-2024)

	Low Case	Central Case	High Case
Cost to government	Zero	Zero	£23.9m
Cost to business	£0.624	£1.2m	£2.6m
Total Cost	£0.624m	£1.2m	£26.5m

6 Risks

77. Under the central scenario presented above, in estimating the costs and benefits of the policy proposal, it was assumed that zero criminal cases for infractions are brought to trial or prosecuted each year[20]. As recognised by the preceding sensitivity analysis, there is a possibility that in practice one or more criminal cases could proceed to trial in any given year over the appraisal period. There is therefore a risk that the estimated costs and benefits in the central scenario may underestimate the actual impacts that transpire.

78. The sensitivity analysis therefore identified the key factors that could affect the magnitudes of the estimated costs and benefits and based on alternative, indicative sets of assumptions shows how the impact may change in low and high cost scenarios.

79. Discussions with stakeholders and responses to the consultation highlighted the risk of misunderstanding of the effects and application of the proposed offences which respondents thought could deter participation in the market. Areas of confusion included the scope of the proposed offences and the meaning of particular concepts such as recklessness. The Government's response to the consultation and guidance will clarify the interpretation of the proposed offences where possible. In working with the proposed offences Ofgem would continue its existing work with market participants to identify areas of concern and, where possible, provide clarification.

7 Wider Impacts

80. The proposal to create criminal sanctions for insider dealing and market manipulation are not expected to directly affect the level of competition through number of producers or suppliers in either the wholesale or retail energy markets, nor would they directly affect the underlying structure of the markets. However, as outlined in the benefits section, to the extent that more transparent price signals in the market increase activity or market entry in the trading, generation, supply or transmission markets, the policy could have beneficial effects. Such affects would result from increased confidence in the integrity of the markets by participants, with further scope for consumer confidence to increase due to greater trust in the fairness of consumer bills which could result in increased consumer engagement. In response to the consultation some stakeholders expressed concern that the existence of criminal offences might deter market entry by some parties, though they did not specify precisely the organisations that may respond in this way. This would be an indirect affect as it would require a change in behaviour by businesses.

[20] This is a simplifying assumption, consistent with 2.3.47 of the Better Regulation Framework Manual, which states "When planning to introduce a regulatory measure, costs and benefits should assume 100% compliance, unless there is evidence of the contrary. However, differing levels of compliance should also be investigated through sensitivity analysis."

8 Direct costs and benefits to business - One in Two Out (OITO)

81. This measure is out of scope of One in Two Out because it is implementing an EU requirement. Creating these criminal sanctions for energy market abuse and insider trading is consistent with the minimum implementation that is required by REMIT and would not therefore be gold-plating. However, under the central case, the estimated cost to business of £1.2 million (NPV, 2014 prices) results in an Equivalent Annual Net Cost to Business (EANCB) of £0.11 million (2009 prices, 2010 NPV base year).

82. Under article 18 of REMIT, the Government was bound by EU law to put in place an enforcement regime for REMIT before the 29 June 2013 (the relevant date in article 18 of REMIT).

83. A general regime of civil sanctions and a criminal regime for the most serious breaches of the core REMIT prohibitions are both needed in order to meet fully the REMIT obligation to put in place "*effective, dissuasive and proportionate*" sanctions that are "*equivalent*" to those in place for similar provisions of domestic law and that reflect the gravity of particular breaches of the REMIT prohibitions. Criminal sanctions encourage the compliance of market participants by focusing the minds of those towards the top of organisations – as well as deterring some people otherwise undeterred by fines. Finally, criminal sanctions have far greater reputational effects than civil sanctions.

84. In 2013, the Government considered that it was not possible to put in place regulations containing criminal offences, which require affirmative resolutions in Parliament, before the implementation deadline of 29 June 2013. However, a civil sanctions regime could be put in place before that date using the negative parliamentary procedure. The Government accepted that to put in place a regime with only civil sanctions would carry the risk of being seen as non-compliant with the obligations in REMIT. The risk was considered acceptable only because of the possibility of putting in place criminal sanctions at the earliest opportunity to complete the enforcement regime.

OITO detailed discussion

85. Remit creates requirements and prohibitions mainly on market participants trading wholesale energy and requires Member States to create penalties for breach of the regulation that

> "*are proportionate, effective and dissuasive, and reflect the gravity of the infringements, the damage caused to consumers and the potential gains from trading on the basis of inside information and market manipulation. The application of these penalties should be carried out in accordance with national law. Recognising the interactions between trading in electricity and natural gas derivative products and trading in actual electricity and natural gas, the penalties for breaches of this Regulation should be in line with the penalties adopted by the Member States in implementing Directive 2003/6/EC*[21]*."*[22]

86. Member States are required to put in place an effective, dissuasive and proportionate sanctions regime. On the subject of penalties REMIT states:

> *"The Member States shall lay down the rules on penalties applicable to infringements of this Regulation and shall take all measures necessary to ensure that they are implemented. The penalties provided for must be effective, dissuasive and proportionate, reflecting the nature,*

[21] https://www.esma.europa.eu/system/files/Dir_03_6.pdf Directive on insider dealing and market manipulation (market abuse)

[22] REMIT paragraph (31) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:326:0001:0016:en:PDF

duration and seriousness of the infringement, the damage caused to consumers and the potential gains from trading on the basis of inside information and market manipulation."[23]

87. When the civil sanctions regime was put in place, it was accepted that this was only meant to be part of a regime which would provide the full suite of *"effective, dissuasive and proportionate"* regulatory responses to REMIT prohibited behaviour. However, significant weight was also given to the benefits for consumers and energy market participants of putting in place a regime to address market abuse at the earliest available opportunity – which meant putting in place civil sanctions regulations separately and first. A criminal sanctions regime, as proposed, deters certain potential behaviour that a purely civil regime does not, and allows for the complete range of punishment for those not deterred.

88. EU law requires that EU obligations are treated in an equivalent way to similar domestic legal obligations. The UK already has criminal sanctions to address insider dealing and market manipulation in financial markets, covering the prohibitions in Directive 2003/6/EC. The proposed option would therefore align REMIT implementation with those financial sector offences, as required by REMIT. In doing so, it would align the regulation of wholesale energy products with good principles of financial regulation. Furthermore, alignment with financial services was identified as important by most respondents to the consultation.

89. The limited criminal offences the Government proposed are proportionate and reflect the gravity of the offences (as required by REMIT). Evidence on the deterrent effect of similar measures in financial services regulation suggests that the proposed offences would be effective in deterring insider dealing and market manipulation. Finally, other Member States have or are putting in place criminal sanctions for breaches of REMIT. The decision to put in place criminal sanctions, though, has to be taken in the context of the different legal and regulatory frameworks of other Member States.

90. Criminal sanctions create important additional deterrent effects including for individuals who would be less influenced by civil sanctions. For this reason, and because of the seriousness of the offences, the Government considers criminal sanctions, in addition to the civil regime, to be necessary to meet the requirements of REMIT, to meet the Government's policy objective of strong sanctions to address the worst examples of market manipulation, and to close the gap with the financial markets regime.

91. The proposed increased sanctions for breaches of REMIT would not create any additional burdens for business. Most respondents to the consultation (12 out of 14) did not envisage any change to their internal processes as a result of the creation of the proposed new offences. Only two stated there could be some additional costs but did not specify what they were or who would face them.

9 Summary of preferred option and implementation plan

92. The preferred option is to introduce criminal sanctions for Article 3 (inside information) and Article 5 (market manipulation) i.e. Option 1, which is considered to be an appropriate and proportionate addition to the regulatory regime for energy markets. Under the central case, the proposal has a net cost of £1.2 million (NPV, 2014 prices) over the appraisal period.

93. Under the proposal market participants who are identified by Ofgem as committing insider dealing or market manipulation would be subject to possible criminal sanctions whether or not they have registered with the regulator. There are greater potential financial gains to market participants from engaging in market abuse than failing to register or provide data, and therefore greater incentives to

[23] REMIT Article 18 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:326:0001:0016:en:PDF

breach the market abuse prohibitions compared to registration and data provision requirements of REMIT.

94. The risk exists that there are market participants who are intent on committing insider dealing or market manipulation because they are insufficiently deterred by the current civil sanctions. Criminal sanctions including potential imprisonment for prohibitions of articles 3 and 5 of REMIT would create an important additional deterrent effect for these offences.

95. The alternative of maintaining the current arrangements (Option 0) is insufficient to meet the stated policy objectives because there is a risk that the deterrent effect on REMIT prohibitions from civil enforcement would not be dissuasive in all circumstances. It would also not fully mitigate the differences in regulation between energy and financial markets regarding market manipulation and insider dealing because the civil sanctions are not as strong a deterrent compared to criminal enforcement.

96. The Government's objective is to legislate as soon as practicable. Not to do so leaves open the possibility that abusive behaviour might occur without an appropriate sanctions regime being in place, given there may be some cases where civil sanctions to do not provide a sufficient deterrent.

97. The use of s.2(2) of the ECA to make the regulations will however mean that sentences could not exceed 2 years and it may be necessary to review the regulations in the light of any revision of UK financial markets legislation in order to align sentences for similar offences.

ANNEX A – SUMMARY OF REMIT REGULATIONS & CIVIL POWERS

1. EU Regulation on wholesale market integrity and transparency (REMIT) is intended to create a regulatory framework which ensures traded wholesale energy markets in the EU function properly – In particular, that energy market prices and outcomes are not distorted by abusive market behaviour, but reflect market fundamentals. It represents the first time insider dealing and market abuse prohibitions have been applied to energy wholesale trades at EU level.

Existing Civil sanctions under REMIT

2. The Government has already regulated to create a civil enforcement regime in June 2013 for market abuse. Those regulations gave Ofgem the following powers (among others):

   - To require regulated persons and others to provide information to enable it to monitor compliance within REMIT and investigate suspected breaches;
   - To levy unlimited financial penalties against those in breach of REMIT;
   - To require restitutionary damages to be paid in respect of profits accrued from or losses suffered as a result of failure to comply with REMIT requirement; and
   - Enforcement powers, including warrants to enter premises.

3. Ofgem is required to cooperate at regional level with The Agency for the Cooperation of Energy Regulators (ACER – an EU agency) in carrying out the monitoring of wholesale energy markets. Ofgem may also monitor trading activity in wholesale energy products at national level. Ofgem is also required to cooperate with ACER and with National Energy Regulatory Authorities (NRAs) of other Member States at regional level to detect trading based on inside information and market manipulation.

4. Ofgem is required to inform ACER of suspected breaches of REMIT either in GB or in another Member State and is required to cooperate with ACER, with other NRAs and certain other authorities, including the Financial Conduct Authority

Table 5: Summary of REMIT Articles

Article	Description
Insider dealing (Article 3)	Insider trading is the trading of a public company's stock or other securities (such as bonds or stock options) by individuals with access to non-public information about the company. In various countries insider trading based on inside information is illegal. This is because it is seen as being unfair to other investors who do not have access to the information. Within REMIT, this means that persons who possess inside information in relation to a wholesale energy product are prohibited by REMIT from buying or selling relevant energy products or disclosing the information or making someone else buy or sell the products.
Prohibition of market manipulation (Article 5)	Prohibition of market manipulation (Article 5) in wholesale energy markets across the UK. Market manipulation is a deliberate attempt to interfere with the free and fair operation of the market and create artificial, false or misleading appearances with respect to the price of, or market for, a security, commodity. Market manipulation

	can be broadly defined as any deliberate attempt to interfere with the fair and open operation of a market to artificially change the market price, or the appearance of the price, of a security, commodity or currency
Data monitoring- Article 8	A monitoring regime for wholesale energy trades (Article 8)- Market participants (or persons listed on their behalf) are required to provide the Agency with a record of wholesale energy market transactions, including the orders to trade. This includes the precise identification of the product; price and quantity agreed and dates and times of execution.
Registration of market participants- Article 9	*Registration of market participants:* Market participants who are required to report to the agency (in accordance with article 8) will need to register with Ofgem.
Article 4	Article 4 - Obligation on market participants to publish inside information in an effective and timely manner (which may exceptionally be delayed in certain circumstances, subject to an obligation to report to ACER and Ofgem, where Ofgem is the relevant National regulatory authority.
Article 7- market monitoring	Ofgem will monitor trading activity in wholesale energy products
Article 10	sharing of information between the Agency (ACER) and other authorities
Article 13	Implementation of prohibitions against market abuse
Article 15	Any persons professionally arranging transactions in wholesale energy products who suspect that a transaction might breach Articles 3/5 must inform Ofgem
Article 17- professional secrecy	Any confidential information received, exchanged or transmitted to the regulation shall be subject to professional secrecy
	The other articles of REMIT are: Article 1 (subject matter, scope); Article 2 (definitions); Article 6 (technical updating of definitions of inside information and market manipulation); Article 11 (data protection); Article 12 (operational reliability); Article 14 (right of appeal); Article 16 (cooperation at Union and national level); Article 18 (penalties); Article 19 (International relations); Article20 (exercise of the delegation)

ANNEX B - SUMMARY OF FINANCIAL SERVICES LEGISLATION

The relationship between financial services regulation and introducing criminal sanctions in energy

1. The UK's regime governing market abuse and inside information in the financial sector consists of both civil and criminal sanctions which are set out by the Financial Services and Markets Act (FSMA) and the Criminal Justice Act (CJA) which enable regulators to seek criminal sanctions of up to seven years' imprisonment for market manipulation and insider dealing.

2. In EU law, the implementation of Market Abuse Directive (MAD) in 2005 created an EU-wide market abuse regime and a framework for establishing a proper flow of information to the financial markets. It was designed to improve confidence in the integrity of the integrated European market and greater cross border co-operation.

3. The FSMA implements MAD in the UK. It introduced a statutory prohibition on market abuse in relation to particular investments on a prescribed market, enforceable by civil penalties. It supplemented the criminal offences of insider dealing and market manipulation because existing criminal and regulatory sanctions, especially in relation to insider dealing did not address all forms of abusive conduct. REMIT definitions of inside information (Article 3) and market manipulation (article 5) are very similar to those in MAD/FSMA. Market Abuse Regulation (MAR) will now replace Market Abuse Directive (MAD). The draft text was agreed by the European Commission in June 2013 but could not be adopted until certain definitions were agreed through the negotiation of MiFID.

4. It is anticipated that MAR will come into force in 2016. MAD (and, in the future, MAR) covers the trading of certain financial instruments. The scope of REMIT is partly determined by that definition of financial instruments; REMIT's scope will change when MAR replaces MAD. The date of the adoption of MAR is still to be decided.

Table 6: Summary of legislation

Legislation	Brief description
Criminal Justice Act 1993 (UK law, implementing Insider Dealing Directive - which preceded MAD)	The CJA sets out the offence of insider dealing. An individual who has information as an insider is guilty of insider dealing, if he deals in defined securities, encourages another person to deal in such securities, or discloses inside information to another person Insider dealing under CJA has a narrower scope than the civil market abuse regime for REMIT.
Financial Services Act 2012 (UK law)	The FSA 2012 transposes enforcement powers under the FSMA 2000 from the FSA to the FCA. Part 7 of the FSA 2012 repeals the misleading statements offence at s.397 of FSMA and creates three new offences including one of misleading statements in relation to relevant benchmarks as well as misleading statements and impressions relating to financial services. These new offences are based on dishonest or reckless conduct but do not require proof of actual market manipulation. The REMIT prohibition of market manipulation has close parallels with the FSA 12 in its reference to misleading statements and impressions.
Market Abuse Directive (MAD)	The implementation of MAD in 2005 created an EU-wide market abuse regime and a framework for establishing a proper flow of

(EU law)/Financial Services and Markets Act 2000 (UK law, implementing MAD), Market Abuse Regulation (MAR)(draft EU law)	information to the market. It was designed to improve confidence in the integrity of the integrated European market and greater cross border co-operation. The FSMA 2000 implements MAD for the UK. It introduced a statutory prohibition on market abuse in relation to particular investments on a prescribed market, enforceable by civil penalties. It supplemented the criminal offences of insider dealing and market manipulation because existing criminal and regulatory sanctions, especially in relation to insider dealing, did not address all forms of abusive conduct. REMIT definitions of inside information (Article 3) and market manipulation (article 5) are very similar to those in MAD/FSMA. MAR will replace MAD. The draft text was agreed in June 2013 but could not be adopted until certain definitions were agreed through the negotiation of MiFID. MAD (and, in the future, MAR) covers the trading of certain financial instruments. The scope of REMIT is partly determined by that definition of financial instruments; REMIT's scope will change when MAR replaces MAD.
Criminal Sanctions Market Abuse Directive (CSMAD) (EU law, not yet in force)	This sets minimum rules on criminal offences and on criminal sanctions for market abuse. The directive defines the offences of insider dealing and market manipulation. It strengthens MAR. It limits the application of criminal sanctions to intentional insider dealing and market manipulation. It requires that criminal sanctions be applied to companies as well as individuals.
Markets in Financial Directive (MiFID II) (draft EU law)	MiFID II improves transparency in the EU around access to trading venues and central counter parties, as well as to benchmarks for trading and clearing purposes. MiFID II • introduces a market structure framework which closes loopholes and ensures trading wherever appropriate takes place on a regulated platform. • Increases equity market transparency • Provides for strengthened supervisory powers • A new framework to improve conditions for completion in trading and clearing of financial instruments For the purposes of REMIT, MiFID II will provide the definitions of financial instruments for the purposes of MAR, which in turn carves certain financial instruments out of REMIT.

ANNEX C - REMIT CRIMINAL SANCTIONS: ANALYSIS OF RESPONSES

Fourteen responses were received to the consultation from a range of organisations including large integrated energy companies, trade associations, sector services organisations, legal organisations, a small supplier, and a private individual.;

Overall summary

- No respondents were able to provide known examples of market manipulation/energy trading. A few respondents highlighted their suspicions about potential cases of market manipulation and insider dealing.
- 12 respondents accepted the case for criminal sanctions and gave cautious support for new criminal offences. Two respondents did not support the case.
- 10 respondents agreed with the case for alignment with financial services. Two respondents did not.
- 12 respondents did not envisage any change to their internal processes or additional costs. Two respondents who did not support criminal sanctions stated there would be some additional costs but did not specify what they were or who would face them.
- 12 respondents did not see any additional benefits or increased confidence in the fairness of the markets. A respondent at the consultation event indicated there could be increased confidence for consumers but not market participants.
- Through the responses and at the stakeholder event respondents identified areas of confusion or concern, many of which were not material to the proposed offences. Respondents welcomed the prospect of clarification and guidance from DECC and Ofgem on a range of issues.

RESPONSES TO CONSULTATION QUESTIONS

Q1: Do you know of any evidence about or examples of energy market manipulation or insider trading practices

None of the 14 respondents were able to provide evidence or specific examples of energy market manipulation or insider trading. However, a few respondents highlighted their suspicions about experienced or potential scenarios including:

- One respondent indicating that counterparties in generator plants could have potential to deal in inside information as it is not clear at what point trading teams become aware if a decision is made about removing generation plant from service.
- Another discussed the process of gross bidding where traders could artificially inflate the demand for day-ahead power.
- One respondent that energy markets are less likely to be open to abuse than financial markets as there is good data on generation and transmission outages which is published frequently and near to real time.
- Another respondent did not agree that the energy market is opaque.

Q2: Should the territorial reach of the regulators' functions in respect of REMIT enforcement should be clarified?

- All the respondents agreed that the territorial function of the regulator, under the enforcement regime should be clarified. One respondent raised concerns that the jurisdictional clause identifying the UK for the purposes of arbitration in many contracts agreed abroad could reduce the demand for GB legal services on international energy trading issues.

Q3: Should create criminal offences for the REMIT prohibitions on insider dealing and market manipulation?

- 12 respondents agreed that new criminal offences for energy market manipulation and inside information should be created. Two respondents did not support the case for new offences.

Q4: Do you agree that the civil enforcement regime that is being created provides an effective deterrence to breaches of the REMIT requirements listed in the 2013 Regulations – including those around registration and the provision of information?

- All respondents to this question agreed that criminal provisions should not be extended to Articles 4, 5, 8, 9 and 15 of REMIT.

Q5: Do you agree that an offence of insider dealing in wholesale energy products should be framed in this way?

- All the respondents to this question agreed that the offence of Insider dealing should be framed as stated in the consultation. Of the two respondents who did not support the case for criminal sanctions, one said the offence should be framed as in the consultation, and the other did not comment.

- All respondents agreed that the offences should only apply in cases of intentional or reckless behaviour.

Q6: Do you consider that the exemptions set out above and in Chapter 4 are appropriate?

- Most respondents agreed that the exemptions on insider dealing were appropriate

- One respondent made a proposal for an additional exemption in the regulations for "inadvertent errors in information". They proposed two options: clarifying that the mental element is "intentional only" or having a safe harbour defence in respect of good faith errors made in provision of information to PRAs.

- Three respondents stated that the exemptions should be similar to those in financial markets and one sought clarification on whether the defences under S53 of CJA/FSMA would be available to market participants.

- Two respondents stated that there should be safeguards or guidance so that recklessness is interpreted so it does not capture accidental behaviour.

- One respondent stated that the exemption for energy market manipulation needs to cover the situation where the person establishes that all their reasons for entering into or refraining from a transaction is legitimate and conforms to accepted market practices. Another respondent wanted clarification on how the offences would be applied in the case of particular market behaviours such as distressed purchasing or selling.

Q7: Do you agree that an offence of insider dealing should include legal persons and decision-makers?

- There was a balanced view here. A number of respondents agreed that the offence of insider dealing should include both legal persons and decision makers.

- One respondent stated that there should be clarity on where a trade is determined by an algorithm such as automated rules based engine or a high frequency trading system

- One respondent stated that if regime applied to both legal and natural persons it needs to define appropriately the behaviour that constitutes a safe harbour defence.

- One respondent stated that the inclusion of legal persons differs to the equivalent offence in financial markets

- One respondent stated that further clarity and guidance was needed on "what constitutes neglect on behalf of an officer".

- One respondent stated that the offence should be limited to a natural person.

- One respondent also stated that potential for corporate liability should be left to the proposed "failure to prevent an economic crime" currently being considered.

- One respondent did not agree that the offence of insider trading should include legal persons and decision makers because there was a risk that the introduction of new offences for key decision makers could reduce physical power trading activity of financial participants.

Q8: Do you agree that the offence of energy market manipulation should be framed in the way described here?

- Most respondents agreed with the framing of the offence of market manipulation including the requirement for intention or recklessness.
- A few respondents indicated that benchmark manipulation goes beyond REMIT.
- Some respondents thought that significant amounts of extra information could be released which could cloud visibility for the market participant and regulator.
- Two respondents suggested changes to proposed approach by aligning the defences and exemptions more closely with REMIT, or including the word "deliberate" in the market manipulation offence, which would provide assurance to market participants that they would be protected when providing information to price reporting agencies.

Q9: Would the creation of these criminal sanctions change the processes that market participants are already putting in place to meet the requirements of the REMIT civil regime?

- 12 respondents agreed that the new offences would not change the processes for market participants, who already comply with the prohibitions under the REMIT civil regime.
- One respondent thought that the new offence could lead directors to take a more risk-averse approach to decision making than that they take under the civil regime (with unlimited fines).
- The two respondents who did not support criminal sanctions stated that the new offences could lead to greater provision of unnecessary information creating an opaque reporting environment and increased costs in employing new staff

Q10: Would the creation of these criminal sanctions change the level of confidence that market participants have in the fairness of the wholesale energy market?

- 12 of the respondents did not envisage any additional benefits or increased confidence in the fairness of the market as a result of the new offences.
- Two respondents stated that it could lead to increased market confidence.
- At the consultation event one stakeholder indicated that the offences would increase confidence for consumers.

RESPONSES ON OTHER ISSUES OF INTEREST

<u>Clarification and guidance</u>

- Respondents indicated a wish for clarity and guidance by Ofgem, ACER and DECC on:

  a) scope - territorial – particularly contracts where the only link to GB is jurisdiction clauses;

  c) whether there is a risk of double jeopardy (prosecution for the same offence under criminal and civil;

  d) information which is "precise" and has "significant effect" on prices; and

  e) role of Ofgem in capacity as policy, investigation and prosecution authority.

<u>Specific Concerns raised by respondents</u>

- Insufficient evidence of market manipulation or inside information already taking place. No specific examples were given of market manipulation, as mentioned above.
- The civil regulations already provide a robust deterrence to wrong-doing and market participants have strong internal compliance processes to comply with REMIT.

- The new offences go beyond the provisions of REMIT, (including benchmarking).
- Could lead to company directors taking a risk adverse approach to price reporting to external agencies.
- Unintended consequences could outweigh the benefits in the application of the offence to companies, directors and officers of those companies who fail to prevent the offence being committed. Three scenarios were described:
    - financial market participants could withdraw from the physical markets, rather than put their directors at risk as a result of a rogue trader;
    - proposed offence of benchmark manipulation could lead undertakings to decide to forbid staff to have contact with PRA's and protect their management from RISK; and
    - international trading of physical energy products could risk being driven away from UK markets to another jurisdiction.
- The perceived risk of new criminal sanctions could lead some market participants to "halt their activities in the NBPM market and to sell their gas, at lower risk, offshore or at the beach".
- The broad nature of the proposed market abuse offences could mean that allegations of market abuse are likely to involve complexities that will make the application of criminal powers to the required burden of proof extremely difficult.
- New criminal offences could dissuade market participants and their respective compliance teams from reporting to PRA's. This could lead to an unintended "chill" the voluntary flow of information from market participants.

<u>Alignment with the financial services regime</u>

- 10 stakeholders agreed on the case for alignment with the financial services regime:
- Some of the respondents supported the argument that alignment between the two regimes would reduce incentives to manipulate the markets. Others stated that the legislative framework, including the defences and exemptions should align as closely as possible with financial services legislation. Two stakeholders did not agree with the case of alignment with the financial services regime: