

EXPLANATORY MEMORANDUM TO
THE ELECTRICITY AND GAS (MARKET INTEGRITY AND TRANSPARENCY)
(CRIMINAL SANCTIONS) REGULATIONS 2015

2015 No. 979

1. This explanatory memorandum has been prepared by the Department of Energy and Climate Change and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. **Purpose of the instrument**

2.1 These Regulations create new criminal offences of wholesale energy market manipulation and insider dealing in wholesale energy market products, behaviour which is prohibited under the EU regulation on wholesale energy market integrity and transparency (Regulation (EU) No 1227/2011) (REMIT)). For the purposes of these regulations, relevant products are wholesale gas and electricity products that meet the definition set out in REMIT. The behaviours captured are certain cases of insider dealing and market manipulation in relation to those products, where there is an appropriate link to the UK. These new offences supplement the existing civil enforcement regime for breaches REMIT. The availability of criminal sanctions to address serious breaches of wholesale energy market rules is intended to ensure there is a suitably dissuasive and proportionate regime to deter and address wholesale energy market abuse.

3. **Matters of special interest to the Joint Committee on Statutory Instruments**

3.1 The Electricity and Gas (Market Integrity and Transparency) (Enforcement etc.) Regulations 2013 (SI 2013 No 1389) for Great Britain, and the Electricity and Gas (Market Integrity and Transparency) (Enforcement etc.) (Northern Ireland) Regulations 2013 (SI 2013 No 208) for Northern Ireland (the REMIT Regulations) put in place an investigatory, enforcement and penalty regime for breaches of REMIT in the United Kingdom. These Regulations are designed to supplement the civil penalties available under the REMIT Regulations by adding criminal penalties for particularly serious cases of breach of Article 3(1) and (5), and 5 of REMIT (which are the relevant REMIT provisions on insider trading and market manipulation).

3.2 The offences created by these Regulations apply to most, but not all of the insider trading and market manipulation prohibitions in REMIT. Offences are limited in various ways as set out below for policy reasons, particularly in view of the particular characteristics of criminal law.

Regulation 3(1)

3.3 Article 3(2) of REMIT lists the persons to whom the prohibition on insider dealing applies. Regulation 3 of the Regulations puts in place criminal sanctions only for a subset of those listed in Article 3(2) of REMIT –those who know or ought to know that the information is inside information, as provided for in Article 3(2)(e). This is because these are the persons whose activity is considered to be the most serious. Other persons listed in Article 3(2) of REMIT will remain subject to the civil penalty regime under the REMIT Regulations.

3.4 Except in rare situations, we consider that persons listed in paragraphs (a) to (d) of Article 3(2) of REMIT will also fall within paragraph (2)(e) of the Article (because, for example, it is likely that a person who is an officer of the company will know that the information they have is inside information). However we consider that it is preferable to limit the criminal the offence to paragraph (e), where the *mens rea* is clear to the court.

3.5 Arguably, we do not need to include both paragraph (c) and paragraph (b) of regulation 3(1), because if a person falls within paragraph (b) they inevitably also fall within paragraph (c) (by virtue of Article 3(2)(e) of REMIT). However, we consider it preferable to include both an explicit reference to REMIT and an explicit requirement that the person “knew or ought to have known” as it ties the offence to breach of REMIT and also makes the *mens rea* clear on the face of the regulations.

Defences in regulation 3(5) to (8)

3.6 The defences in paragraphs (5) and (6) of regulation 3 do again give effect to the policy decision that the scope of the criminal offences should be limited to a subset of the REMIT prohibition. We considered that such an approach is compatible with EU law, as there is a civil sanctions regime in the REMIT regulations which is coextensive with REMIT.

3.7 The purpose of the defence in regulation 3(6) is to cater for the position where there is information which turns out in fact to be inside information but the defendant reasonably (though wrongly) believed that it had been or would be disclosed sufficiently for it to lose its character as “inside information”. Consequently, belief in disclosure is a necessary element of the defence.

Regulation 4 (market manipulation)

3.8 Regulation 4 imposes a criminal offence for market manipulation. Article 2(2)(a) of REMIT defines “market manipulation”. Regulation 4(1) covers market manipulation as set out in Article 2(2)(a)(i) and Article 2(2)(a)(iii) of REMIT, and regulation 4(2) covers market manipulation as set out in Article 2(2)(a)(ii) of REMIT. We do not consider it appropriate to impose separate offences for the activity covered by Article 2(2)(a)(i) and the activity covered by Article 2(2)(a)(iii) of REMIT, because we consider that the activity covered by Article 2(2)(a)(iii) should properly be seen as a subset of Article 2(2)(a)(i). However, in order to ensure that any jurisprudence of the EU Court of Justice and guidance from EU bodies relating to either Article 2(2)(a)(iii) or Article

2(2)(a)(i) has a reference point in the Regulations, we have included a reference to Article 2(2)(a)(iii) as well as Article 2(2)(a)(i) in regulation 4.

Regulation 9

3.9 Regulation 9 requires enforcement guidance to be published by Ofgem and NIAUR. However, others, such as the Director of Public Prosecutions, the Lord Advocate and the Secretary of State are also prosecutors under regulation 10.

3.10 We consider that the primary prosecution authority would be Ofgem or NIAUR. We considered that existing guidance on prosecutions from other prosecutors, such as the CPS Code for Crown Prosecutors, made such guidance requirement as that in regulation 9 unnecessary.

3.11 In relation to the Secretary of State, and the Department for Enterprise, Trade and Investment, we do not consider it necessary for policy to be issued for the extremely unlikely situation where the Secretary of State uses what we consider to be a residual power to bring a prosecution.

Regulation 10

3.12 Regulation 10 sets out who may institute proceedings for an offence under the Regulations, in England and Wales and Northern Ireland. There is no equivalent provision for Scotland. The approach, silence in relation to Scotland, is due to the particular nature of proceedings in Scotland. The legal position in Scotland is that the Lord Advocate has an inherent common law power to prosecute any offence (statutory or otherwise). All statute can do is remove that power or confer it on additional people, hence it is considered undesirable to reiterate it in legislation. Consequently, we considered silence to be the appropriate approach.

3.13 In practical terms, and unlike in England and Wales, and Northern Ireland, prosecutions are only taken by the Lord Advocate (so, for instance, we expect Ofgem to hand over any case to the Lord Advocate to prosecute).

4. Legislative Context

REMIT

4.1 REMIT prohibits insider dealing and market manipulation in wholesale energy markets and establishes a monitoring regime for wholesale energy trades. The Government created a civil enforcement regime for breaches of REMIT through regulations in June 2013 in Great Britain (The Electricity and Gas (Market Integrity and Transparency) (Enforcement etc.) Regulations 2013, SI 2013 No 1389). A similar regime was created in Northern Ireland by the Transparency) (Enforcement etc.) (Northern Ireland) Regulations 2013 SI 2013 No 208 regulations that came into force on 31 August 2013. Under these regimes, the relevant utility regulator¹ has the ability to require

¹ The Gas and Electricity Markets Authority (GEMA) in Great Britain and

information, carry out inspections, and impose unlimited fines for insider dealing and market manipulation.

Financial markets legislation

4.2 The UK's regime governing market abuse and inside information in the financial sector consists of both civil and criminal offences which are set out by the Financial Services and Markets Act (FSMA) 2000, the Financial Services Act (FSA) 2012 and the Criminal Justice Act (CJA) 1993 which enable the regulator, amongst other things, to seek criminal sanctions of up to seven years' imprisonment for market manipulation and insider dealing.

4.3 In EU law, the implementation of the Market Abuse Directive (Directive 2003/6/EC) (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.

4.4 REMIT definitions of inside information (article 3) and market manipulation (article 5) are very similar to those in MAD and existing UK legislation.

4.5 The EU Market Abuse Regulation (Regulation (EU) No 596/2014) (MAR) will now replace the MAD. The draft text of MAR was agreed by the European Commission in June 2013 but could not be adopted until certain definitions were agreed through the negotiation of Directive on markets in financial instruments (Directive 2014/65/EU) (MiFID2). 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 contained within MiFID2; REMIT's scope will change when MAR replaces MAD. MAR was published in the EU Official Journal and the majority its provisions will apply from 3 July 2016.

5. Territorial Extent and Application

5.1 This instrument applies to the United Kingdom.

6. European Convention on Human Rights

6.1 The Secretary of State for Energy and Climate Change has made the following statement regarding Human Rights:

In my view the provisions of The Electricity and Gas (Market Integrity and Transparency) (Criminal Sanctions) Regulations 2015 are compatible with the Convention rights.

7. Policy background

7.1 The UK wholesale energy markets are of great significance to the UK economy and to Europe as a whole. For example, trading on the GB wholesale energy markets has been estimated to be worth between £297bn and £333.5bn each year. In addition to this figure a significant volume of trading of European energy products is done through London-based brokers. The value of the European gas market being traded through the UK is an estimated £282 billion² in 2013. The UK provides a trading hub for gas; the GB liquid gas market is used as a reference price for gas delivered elsewhere in Europe and into the electricity market where gas is a significant and sometimes marginal (price-setting) fuel.

7.2 The large figures involved and the importance of the wholesale energy market for financial services, industry and UK and European consumers make the integrity of the market a matter of national and international importance.

7.3 REMIT has been in force since 28 December 2011. REMIT prohibits insider trading and market manipulation in wholesale energy markets across the EU and establishes a monitoring regime for wholesale energy trades by:

- introducing explicit prohibitions of market manipulation, attempted market manipulation and insider trading in wholesale energy markets;
- requiring the effective and timely public disclosure of inside information by market participants;
- introducing an obligation to report suspicious transactions;
- establishing a new framework for the monitoring of wholesale energy markets to detect and deter market manipulation and insider trading; and
- requiring national regulatory authorities (NRAs) to be given enforcement and investigatory powers and requiring member states to establish a penalty regime for sanctioning of breaches at a national level.

7.4 The 2013 Regulations gave the UK regulators the power to request any relevant information; carry out onsite inspections; and impose unlimited fines for breaches of a REMIT requirement or prohibition.

7.5 The Government announced in the Annual Energy Statement in October 2013³, that we would consult on strengthening the existing civil enforcement regime by creating new criminal offences in line with the prohibitions relating to market abuse in REMIT.

²Actual brokered over the counter energy data was used (Source: London Energy Brokers Association), plus the additional estimated proportion of that market that is not OTC. 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. http://www.leba.org.uk/pages/index.cfm?page_id=4

³ <https://www.gov.uk/government/publications/annual-energy-statement-2013>

8. Consultation outcome

8.1 The Government consulted publicly through August and September 2014 and held a joint stakeholder event on the proposals with Energy UK which 30 industry organisations attended. Fourteen responses were received to the consultation from a range of organisations including large vertically integrated energy companies, trade associations, sector services organisations, legal organisations, a small supplier, and a private individual. The key messages from the consultation were:

- 12 out of the 14 respondents to the consultation accepted the case for criminal sanctions and gave cautious support for the proposed legislative approach. Two respondents did not support the case for criminal sanctions.
- 10 out of the 14 respondents to the consultation agreed with the case for alignment with financial services. Two respondents did not.
- 12 out of the 14 respondents to the consultation did not envisage any change to their internal processes or additional costs. Two respondents who did not support criminal sanctions stated there may be some additional costs but did not specify what they were or who would face them.
- 12 out of the 14 respondents to the consultation 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 for market participants.
- Through their responses and at the stakeholder event respondents identified areas of uncertainty many of which were not material to the proposed offences. Respondents welcomed the prospect of clarification from DECC, which we are providing in the Government's response, and further guidance from Ofgem on a range of issues.
- None of the respondents provided specific examples of energy market manipulation or insider trading.

8.2 Having considered views expressed through the consultation and stakeholder event on the 26th September the Government has prepared and laid before Parliament these regulations creating the offences of insider dealing and market manipulation as set out in chapters 2 and 3 of the consultation.

8.3 There was one aspect of the proposals to which particular concern was expressed. It was the proposed extension of the offences to include contracts in which the only link to the UK is a dispute resolution clause. In practice, such contracts would either be unlikely to be breaching REMIT (if the subject matter of the transaction was wholly outside the EU) or would be under the jurisdiction of another Member State (if partly in the EU). Stakeholders expressed concern that this proposal might nonetheless cause a degree of jurisdictional flight with potential implications for the UK legal services sector.

8.4 The Government has weighed this potential impact on UK businesses against the very small chance that there is market abuse that the Government would wish to be

captured where this is the only link to the UK. Excluding such contracts would have no or little impact on the market manipulation or insider trading in GB or the EU. These Regulations therefore do not extend to including such contracts.

9. Guidance

9.1 The Regulations require regulators to produce guidance for market participants regarding its approach to prosecuting the new offences.

10. Impact

10.1 The impact on compliant businesses would be the indirect opportunity cost of the estimated costs set out below for Ofgem because it is funded by industry licence fees. There is no impact on charities or voluntary bodies.

10.2 The impact on the public sector would be an estimated cost of £150,000 on Ofgem's monitoring and investigatory operation. This cost would be met through efficiency savings so will not result in an increased cost to business but represents an indirect opportunity cost to licence fee paying businesses.

10.3 An Impact Assessment is attached to this memorandum and is published alongside the Explanatory Memorandum on the legislation.gov.uk website.

11. Regulating small business

11.1 The legislation would apply to small business. The nature of energy dealing is such that small businesses are able to deal in wholesale energy products in ways that can create similar risks for other market participants as larger businesses. Applying the legislation to small businesses would therefore be appropriate in this case.

12. Monitoring & review

12.1 The Secretary of State for Energy and Climate Change will review these regulations not less than five years after they come into force and at least every five years thereafter. In reviewing their impact he will have to have particular regard to their effect in relation to the implementation of REMIT in other European Union Member States and the financial market regime as it is developed in the UK.

13. Contact

13.1 Jonathan Robinson at the Department of Energy and Climate Change Tel: 0300 068 5944 or email: jonathan.robinson@decc.gsi.gov.uk can answer any queries regarding the instrument.