FINANCIAL MARKETS LAW COMMITTEE

28 October 2014

Charles Roxburgh
Director General, Financial Services
HM Treasury
1 Horse Guards Road
London
SW1A2HQ

Dear Mr Roxburgh,

Recommendations of the Fair and Effective Markets Review

The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

The FMLC takes note of the proposals of HM Treasury, in the context of the Fair and Effective Markets Review, to bring seven additional benchmarks within the scope of the UK regulatory framework for benchmarks (the "**Benchmark Consultation**").[1] The FMLC also takes note of the consultation published on 6 August 2014 by the Department of Energy and Climate Change (the "**DECC**") proposing to create new criminal offences of insider trading and market manipulation in the context of wholesale energy markets, including a new offence of benchmark manipulation (the "**DECC Consultation**").[2]

The FMLC has previously considered whether any issues of legal uncertainty arise in the context of the DECC Consultation, and concluded that any such issues that do arise are of insufficient materiality to warrant further action by the FMLC at this stage. The FMLC has, however, identified a number of anomalies, set out in the enclosed research paper, which it wishes to bring to the attention of HM Treasury for its consideration in the context of the Benchmark Consultation.

I and Members of the Committee would be delighted to meet with you to discuss the issues regarding the proposals. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely

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[1] Available at: https://www.gov.uk/government/consultations/fair-and-effective-market-reviews-benchmarks-to-bring-into-uk-regulatory-scope

[2] Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/341293/remit_criminal_sanctions_consultation_final.pdf

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Research Note

Department of Energy and Climate Change – Consultation on Strengthening the Regulation of Wholesale Energy Markets Through New Criminal Offences

EU Regulation No 1227/2011 of 25 October 2011 on Wholesale Energy Market Integrity and Transparency (the "**REMIT**") prohibits insider trading and market manipulation relating to "wholesale energy products" ("**WEPs**"). WEPs are defined in the REMIT to include "derivatives relating to electricity or natural gas produced, traded or delivered in the Union" and "derivatives relating to the transportation of electricity or natural gas in the Union".[1] The REMIT excludes from the scope of application of the prohibitions on insider trading and market manipulation WEPs which are financial instruments to which Article 9 of Directive 2003/6/EC (the "**Market Abuse Directive**") applies[2], i.e. "any financial instruments admitted to trading on a regulated market [...], or for which a request for admission to trading on such a market has been made". *A contrario*, financial instruments neither admitted nor subject to a request for admission to trading on a regulated market (for example, financial instruments traded on a multilateral trading facility) fall within the scope of the REMIT prohibitions.[3]

The REMIT provides that Member States shall lay down the rules on penalties applicable to infringements of its requirements, provided that such penalties are "effective, dissuasive and proportionate".[4] The Electricity and Gas (Market Integrity and Transparency) (Enforcement etc.) Regulations 2013 (the "**Regulations**"), which came into force on 29 June 2013,

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1 Articles 2(4)(b) and (d) of the REMIT.

2 Article 1(2) of the REMIT.

3 Regulation (EU) No 596/2014 of 16 April 2014 on market abuse (the "**Market Abuse Regulation**") will, from 3 July 2016, extend the European insider dealing and market manipulation regimes to cover, *inter alia*, financial instruments (as defined in Directive 2014/65/EU of 15 May 2014 ("**MiFID II**")) traded on a regulated market, multilateral trading facility or organised trading facility (and instruments the price or value of which depends on or has an effect on the price or value of a such financial instruments). If the exclusion from the scope of the REMIT is similarly extended, this will also exclude such financial instruments from the scope of the offences currently proposed in the Consultation, reducing their application with respect to derivatives.

4 Article 18 of the REMIT.

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established in the UK a civil enforcement mechanism for the REMIT. On 6 August 2014, the Department of Energy and Climate Change (the "**DECC**") published a consultation proposing to strengthen the REMIT enforcement regime in the UK through the creation of new criminal offences of insider trading and market manipulation in the context of wholesale energy markets (the "**Consultation**"). Such regime would be policed in Great Britain by the Office of Gas and Energy Markets ("**Ofgem**").

The FMLC is of the view that the Consultation gives rise to a number of anomalies, as further set out below.

1. **Legal Basis**

   The legal basis for certain elements of the proposed new offences is unclear. Article 18 of the REMIT grants the power for Member States to "lay down the rules on penalties applicable to infringements [...]". The DECC is proposing to introduce the new offences using the power conferred under section 2(2) of the European Communities Act 1972, (the "**ECA**"), which is exercisable only "for the purpose of implementing any Community obligation of the United Kingdom", under section 2(2)(a), or "dealing with matters arising out of or related to any such obligation", under section 2(2)(b). Where the proposed new offences differ materially from the prohibitions set out in the REMIT, it is unclear whether they will satisfy this test.

   In addition, differences between the proposed new offences and the prohibitions set out in the REMIT may have the effect that the scope of the civil enforcement mechanisms under the Regulations differs from that of the proposed new criminal offences: the Regulations provide civil remedies for breaches of "REMIT requirements", defined by way of cross-reference to the text of the REMIT itself.

   Examples of such material differences include the following requirements set out in the Consultation.

   a. The proposed offences of insider trading and market manipulation set out in the Consultation only apply where the relevant conduct is carried out "intentionally or recklessly".[5] The REMIT does not restrict the prohibitions of insider trading or market manipulation by requiring the presence of such mental element, which arguably, therefore, results in the offences failing to meet the "effective, dissuasive and proportionate" criteria required by the REMIT.

[5] Paragraph 3.20 and 4.8 of the Consultation.

b. The Consultation defines the offence of market manipulation as where a person "makes a false or misleading statement, conceals a fact or creates a misleading impression which is liable to induce another person to take certain actions relating to a wholesale energy product or the rights it confers".[6] This wording is not contained in the REMIT and arguably unduly narrows the scope of the offence (in particular through the wording "is liable to induce [...]").

c. The Consultation proposes that the offence of energy market manipulation include the manipulation of benchmarks, i.e.:

   i. "providing false information to undertakings which provide price assessments or market reports with the effect of misleading market participants acting on the basis of those price assessments or market reports; or

   ii. offering, buying or selling wholesale energy products with the purpose, intention or effect of misleading market participants acting on the basis of reference prices".[7]

   The REMIT does not specifically provide for a prohibition on the manipulation of benchmarks. To the extent that this type of activity already falls within the other limbs of the offence of market manipulation (and therefore within the scope of the REMIT prohibition), it is arguably otiose; if, on the other hand, it does not, then the legal basis for extending the offence is unclear.

2. Overlap with Existing Financial Services Offences

2.1. Market Manipulation

There is overlap between the proposed new offence of market manipulation and the offences relating to financial services set out in Part 7 of the Financial Services Act 2012 (the "**FSA**"). The latter carry a maximum penalty of imprisonment for a term of seven years and/or a fine,[8] while it is proposed for the former to be punishable by a

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6 Paragraph 4.2 of the Consultation.

7 Paragraph 4.11 of the Consultation.

8 Section 92 of the FSA.

maximum two-year prison sentence. To the extent of the overlap, the same criminal conduct would incur two differing sanctions.

The proposed new offence of market manipulation has three limbs, namely where a person

i. makes a false or misleading statement ("**Limb A**");

ii. conceals a fact ("**Limb B**"); or

iii. creates a misleading impression ("**Limb C**"),

in each case, which is liable to induce another to take certain actions relating to a WEP or the rights it confers.[9] As noted above, a WEP includes "derivatives relating to electricity or natural gas produced, traded or delivered in the Union" and "derivatives relating to the transportation of electricity or natural gas in the Union".

Limbs A and B of this new offence appear partially[10] to overlap with section 89 of the FSA, under which a person ("P") commits an offence, *inter alia*,

> "if P makes [a statement which is false or misleading in a material respect, being reckless as to whether it is] or conceals [any material facts] with the intention of inducing, or is reckless as to whether making it or concealing them may induce another person [...]
>
> i. to enter into or offer to enter into, or to refrain from entering or offering to enter into, a relevant agreement; or
>
> ii. to exercise, or refrain from exercising any rights conferred by a relevant investment."

The definitions of "relevant agreement" and "relevant investment" are broad, and cross refer to the Financial Promotion Order[11] and the Regulated Activities Order.[12]

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9 Paragraph 4.2 of the Consultation.

10 The two regimes are not, however, coextensive: physically-settled derivatives, as well as derivatives entered into for commercial, as opposed to investment, purposes probably do not fall within the scope of the FSA offences.

11 Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "**Financial Promotion Order**").

12 Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 (the "**Regulated Activities Order**").

Relevant investments therefore include, for example, commodity futures (including forwards)[13] made for investment (but not commercial[14]) purposes, and contracts for differences (broadly defined to capture most cash-settled derivatives).[15]

Equally, under section 90 of the FSA, P commits an offence if P

> "does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any relevant investment [...] if P intends, by creating the impression, to induce another person to acquire, dispose of, subscribe or underwrite the investments or to refrain from doing so [...]".

This appears to overlap with Limb C of the proposed new offence of market manipulation in relation to WEPs.

2.2. Benchmark Manipulation

As set out above (see paragraph 1(c)), the Consultation proposes an offence of benchmark manipulation.

Making misleading statements in relation to "relevant benchmarks" is a criminal offence under section 91 of the FSA. To date, only LIBOR has been specified as a "relevant benchmark".[16] In the context of the Fair and Effective Markets Review, HM Treasury has, however, proposed[17] to specify further benchmarks as "relevant benchmarks", including certain commodity benchmarks (London Gold Fixing, LBMA Silver Price and ICE Brent). The current proposals do not appear to consider there to be a case to extend, within the universe of commodity benchmarks, the regulatory regime to sectors other than precious metals and crude oil at present.[18] As a consequence, (i) manipulating a "relevant benchmark" (e.g. ICE Brent, should the current proposals be adopted) would incur a maximum seven-year prison term, but *per* the Consultation the same conduct in relation to an electricity or natural gas benchmark would incur a maximum sentence of two years (see paragraph 3 below in

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13 Broadly defined as "rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed on when the contract is made".

14 Article 22(2) of Part 2, Schedule 1 of the Financial Promotion Order.

15 Article 23 of Part 2, Schedule 1 of the Financial Promotion Order.

16 Under Article 3 of the Financial Services Act 2012 (Misleading Statements and Impressions) Order 2013.

17 Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. X) Order 2014.

18 Recommendations on additional financial benchmarks to be brought into UK regulatory scope, Report to HM Treasury, Fair and Effective Markets Review, August 2014.

relation to penalties for further discussion); and (ii) should electricity and/or natural gas benchmarks ever be specified as "relevant benchmarks", the two offences would overlap.

3. Penalties

In the context of financial markets, the maximum prison sentence that can be imposed under the UK regime for misleading statements (including in relation to benchmarks), misleading impressions and insider dealing is seven years.[19] The penalties for the new criminal offences proposed under the Consultation are instead subject to a two-year cap on the term for imprisonment. This is because no new offence punishable by a prison sentence in excess of two years can be created under the power conferred by section 2(2) of the ECA,[20] under which the new offences are proposed to be introduced, for reasons of expediency (as explicitly recognised in the Consultation[21]). Absent a clear justification for the difference in treatment vis-à-vis the financial markets offences, it is unclear whether a maximum two year penalty will meet the "effective [and] dissuasive" requirement set out in the REMIT.

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19 Under section 61 of the Criminal Justice Act 1993 and section 92 of the FSA.

20 Schedule 2, paragraph 1(1) of the ECA.

21 As set out in paragraph 2.12 of the Consultation, "putting in place criminal offences with longer maximum sentences would require primary legislation, and that would take considerably longer to implement".