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20 January 2012

Elio Zammuto
GB Markets
9 Millbank
London
SW1P 3GE

Dear Mr. Zammuto,

GFMA comments on the Regulation on Energy Market Integrity and Transparency

The members of the commodity markets working group of the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and Asia Securities Industry and Financial Markets Association (ASIFMA), working together as the Global Financial Markets Association¹ (GFMA) welcome the opportunity to provide comments to the Office of Gas and Electricity Markets (Ofgem) on the potential impact of the Regulation on Energy Market Integrity and Transparency (REMIT) on their business. Our members are keen to maintain an active dialogue with Ofgem and with the Association for Co-operation of Energy Regulators (ACER) throughout the process of implementation of REMIT, and would therefore like to offer some constructive comments that we hope will serve as part of that ongoing dialogue.

Banks and other financial institutions perform a vital role in wholesale energy markets, acting as traders and intermediaries, assuming risk and putting their capital to work providing liquidity to the market. They do not generally own production or transportation facilities, so they would not typically be in possession of information about capacity and use of facilities, or planned or unplanned availability of facilities. The only non-public information that banks and financial institutions would typically possess would be information on their own trading and information derived from dealing with counterparties. For example, as a result of their trading activities they may acquire

¹ The Global Financial Markets Association (GFMA) joins together some of the world's largest financial trade associations to develop strategies for global policy issues in the financial markets, and promote coordinated advocacy efforts. The member trade associations count the world's largest financial markets participants as their members. GFMA currently has three members: the Association for Financial Markets in Europe (AFME), the Asia Securities Industry & Financial Markets Association (ASIFMA), and, in North America, the Securities Industry and Financial Markets Association (SIFMA).

information about the transactions they enter into and about supply and demand in relation to those transactions.

Our members are concerned that, unless REMIT is applied in an appropriate way, non-public information necessarily acquired in the course of their trading operations may interrupt their ability to hedge and to perform their contractual obligations.

In many cases, due to the scale of the relevant markets, non-public information may not be price sensitive. However, it is not possible in a fast moving trading environment to evaluate every piece of information to determine whether or not it may be price sensitive. As a result, financial institutions are likely to take the approach that any non-public information is price sensitive, particularly given the reputational implications and other consequences under REMIT if the information is subsequently determined to be inside information.

Scope of the insider dealing offence under REMIT

We think it is essential that Ofgem and ACER understand that unless applied appropriately REMIT risks disrupting supply and endangering the market, leaving consumers facing higher costs as many producers find they cannot hedge their price risk. In particular, it is important that Ofgem and ACER recognise that market participants who lawfully engage in trading activity may acquire non-public information in the course of this activity, and that this should not necessarily prevent them from trading or from acting to hedge losses arising from unexpected market events.

We set out below by way of illustration a practical example of the application of the insider dealing provisions under REMIT.

An EU financial institution has entered into an over-the-counter (OTC) contract to buy a cargo of LNG from a Middle Eastern terminal which it intends to bring to South Hook and sell onward. The risk might be hedged via the National Balancing Point, either OTC or on an exchange such as ICE. With a day to go before delivery the supplier calls a force majeure event, and notifies the EU financial institution that it will not be able to deliver, and the reasons for its failure to deliver.

The EU financial institution also has onward delivery obligations depending on delivery under this contract which it will now be unable to meet. As a result, it will need either to close out its hedges or to acquire an alternative supply of LNG to cover its delivery obligations. If REMIT is not applied appropriately, there is a risk that it will not be able to do so.

The information provided by the supplier on the force majeure event is likely to be precise, as the supplier needs to justify its failure to perform its contractual obligations. It is also likely that the information will not be public (even if several participants know about it). In addition, the information may be price sensitive if the shipment is sufficiently large or important, or if the event which has resulted in the failure to deliver is important to the market.

In the time available, the financial institution may not be able to evaluate whether the information is in fact price sensitive, so will need to assume that it is. As a result, it is likely to have to treat itself as being in possession of inside information in relation to a wholesale energy product, and unless REMIT is applied appropriately it may be prohibited from using that information to acquire or dispose of wholesale energy products to which that information relates until the information has been made public.

However, the supplier may not make the information public. For example, it may not consider that it is a market participant subject to the obligation to publish information under Article 4 of REMIT. In our example, the supplier is not located in the EU, and where it enters into an OTC contract with an EU counterparty it may not consider itself to be entering into a transaction in a wholesale energy market in the EU, but rather that the EU financial institution is entering into a transaction in a Middle Eastern energy market. As a result, the supplier may not consider that it is obliged to publish the information under Article 4 of REMIT.

The financial institution would also not be required under REMIT to make the information public, as the information is not information about its "business or facilities". In addition, the financial institution may be prevented from making the information public voluntarily, as a result of confidentiality obligations in the contract with its counterparty. These confidentiality obligations would typically contain an exception for disclosure of information where required by applicable law, but this exception would not be available in these circumstances. In addition, there are likely to be commercial sensitivities regarding publication of information about a counterparty's business without its consent.

Unless the relevant provisions under REMIT are interpreted to permit market participants to trade when they are in possession of information acquired through their legitimate trading activities, the financial institution will be unable either to make the information public or to unwind its hedges or seek an alternate supply of LNG until the information becomes public, with the result that it will become exposed to price risk.

Our members are concerned that legislation which prevents a party from making the decision as to whether or not to go out and cover if their counterparty is calling force majeure is likely to stifle market efficiencies as participants will be reluctant to trade if they cannot be certain that they will be able to manage their exposures appropriately.

Examples of defences and safe harbours in the Market Abuse Directive

Ofgem and ACER should consider aligning their approach to implementation of REMIT with the approach adopted by securities markets regulators under the Market Abuse Directive.

It is clear that REMIT is intended to extend the insider dealing offence under the Market Abuse Directive (2003/6/EU) to apply to wholesale energy markets. The equivalent provisions on insider dealing in the Market Abuse Directive are almost identical.

Like REMIT, the Market Abuse Directive does not contain explicit defences for parties who come into possession of information as a result of their trading activities. However, the recitals to the Market Abuse Directive do recognise that market makers, bodies authorised to act as counterparties or persons authorised to execute orders on behalf of third parties with information may pursue their legitimate business of buying or selling financial instruments without being considered to be using inside information (recital 18).

Banks and other financial institutions perform a similar role in the wholesale energy markets, and equally should not be considered to be using inside information where they pursue their legitimate trading activities while in possession of inside information arising necessarily from those trading activities.

This approach is supported by the decision of the European Court of Justice (ECJ) in *Spector Photo NV v CBFA (Case C-45/08)* which, while it recognised a strict approach to the "use of" inside information², also recognised that this strict approach would give rise to injustice and impede the efficient operation of the markets, and indicated that a person would be able to establish a defence in some circumstances.

While the decision did not set out an exhaustive list of what those circumstances might be, the ECJ recognised that the recitals to the Market Abuse Directive provide several examples of situations where a person should not be considered to be using inside

² The ECJ held that a person would be regarded as using inside information if he dealt while in possession of that information, even if the information had no influence on the decision to deal.

information, including where a market participant pursues their legitimate business of buying or selling financial instruments.

The FSA's approach to the Market Abuse Directive

A clear example of the application of these principles is set out in the Code of Market Conduct (MAR) issued by the UK Financial Services Authority (FSA), which provides guidance on how the FSA applies the Market Abuse Directive.

In particular, MAR 1.3.7C provides that "for market makers and persons that may lawfully deal in qualifying investments or related investments on their own account, pursuing their legitimate business of such dealing [...] will not in itself amount to market abuse (insider dealing)". MAR 1.3.7C applies even if a person possesses trading information which is inside information. This provides a clear safe harbour for persons dealing while in possession of trading information.

In the context of information in relation to securities, "trading information" is defined narrowly to mean information relating directly to trading in securities (e.g., information that securities of a particular kind will be acquired or disposed of, and information on price, quantity, identity of market participants). As a result, if this definition was applied to trading in wholesale energy markets without any consideration for the differences between those markets and securities markets, "trading information" would include information on the consequences of a force majeure event (i.e. the counterparty's intention not to perform), but would not cover the information that counterparties would necessarily acquire in relation to the reason for the force majeure event. However, the FSA's guidance does state that where a person deals on the basis of inside information which is not purely trading information this is only an indication that the dealing is not legitimate, and sets out a number of factors which may also be taken into account to indicate legitimate dealing (including the extent to which the relevant trading by the person is carried out in order to hedge a risk).

Given the broader definition of "inside information" in relation to wholesale energy markets under REMIT, and the wider range of information that market participants may acquire in the course of their legitimate trading activity, it would be appropriate to adopt an approach aligned with that adopted by the FSA, but with an appropriately modified definition of "trading information" designed to reflect the needs of the wholesale energy markets.

We would welcome the opportunity to develop an ongoing dialogue with Ofgem and ACER on these and other issues of importance to the wholesale energy markets.

Yours sincerely,

A handwritten signature in black ink, appearing to read "T. Ryan, Jr.", with a long horizontal flourish extending to the right.

T. Timothy Ryan, Jr.
CEO
GFMA