

## Financial regulation and energy regulation – not so different now

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In Europe, one of the big trends in energy trading markets has been for market participants to increasingly face rules akin to those that apply in the financial markets. This is for two reasons: Financial regulators are extending the reach of their rules to impact more directly energy markets and their participants; and energy regulators are developing rules that take their inspiration from those governing the financial markets. *This Client Alert* highlights these trends in three key areas and considers what they mean for energy trading businesses, be they part of banks, utilities or trading companies.

### ***Insider trading and disclosure***

It has been long-accepted in securities markets that equal access to information protects market integrity and confidence. Non-public price-sensitive information should be disclosed to the market, and people who trade using that information before it is disclosed should be punished. This is the underlying reason for having insider trading laws.

Energy and commodity markets have taken a different approach. These markets do not have wide-ranging disclosure regimes. Energy companies facing physical disruptions (such as unscheduled maintenance) have largely been free to use that information in their trading before the market becomes aware of it.

Under the Market Abuse Directive (MAD), Europe introduced an insider trading and market manipulation regime for commodity derivatives traded on regulated markets. But the insider trading rules are toothless because of the narrow definition of "inside information". In other markets the definition picks up non-public information that has a significant effect on price. The commodity derivatives definition requires the information be that which market users would expect to receive in accordance with "accepted market practices" on those markets. As commodity derivatives markets do not tend to require companies to disclose information about their energy and commodities activities, there is not much inside information on which a regulator can base an insider trading case under MAD.

That position is now changing. In October, the European Commission is expected formally to propose amending MAD to align the definition of inside information for commodity derivatives with that for other financial instruments. This will expand the scope of "inside information" for commodity derivatives.

Energy regulators are also getting in on the act. The European authorities are developing a specific insider dealing and market manipulation framework for the power and gas markets. Under the Regulation on Energy Market Integrity and Transparency (REMIT):

- energy companies will be required to disclose non-public information about facilities they own or control that could have a significant effect on the price of wholesale gas or power; and
- a person with non-public information that could have a significant effect on wholesale gas or power prices will be prohibited from trading on the basis of that information. The securities market theory about preventing insiders benefitting from their greater access to information will be fully extended to the gas, power and commodity derivatives markets.

## ***Exchanges and markets***

Exchanges bringing together multiple buyers and sellers of financial instruments, including commodity derivatives, are regulated in Europe as "regulated markets" or "multilateral trading facilities". There has been no European regulatory regime for exchanges on which spot energy and emissions products are traded. That may not last.

Under the EU Emissions Trading Scheme, many EU emissions allowances will now be auctioned. The Regulation governing this<sup>1</sup> requires that the auction platform be a regulated market, even where the products being auctioned are spot allowances and thus do not constitute financial instruments. This enables the regime to piggy-back off the requirements that regulated markets must meet to ensure proper markets.

Energy regulators are also looking to introduce a regulatory regime for spot energy exchanges. In a consultation published in April<sup>2</sup>, the European gas and electricity regulators recommended that national energy regulators be given responsibility under European law for approving the overall market design (including the rules) of spot energy exchanges. New rules in this area are likely to cover similar subjects to rules governing regulated markets (e.g., adequate market surveillance, transparency, and market making).

## ***Licensing***

As things stand, dealing in commodity derivatives falls within the scope of the licensing regime for those providing investment services and carrying on investment activities under the Markets in Financial Instruments Directive (MiFID). But the commodity market exemptions in MiFID ensure that most non-financial institutions dealing in commodity derivatives can structure themselves to fall outside the scope of that regime. Where such firms do fall within MiFID, there is an exemption from the bank-style capital adequacy regime that would otherwise apply.

Under the MiFID review, the European Commission likely will propose that the commodity market exemptions be removed or narrowed. Once the revised MiFID is in force, energy companies trading in commodity derivatives will find it more difficult to avoid being subject to financial services licensing and the conduct of business and organisation requirements that thereby follow. The exemption from capital adequacy rules for such firms is also due to fall away. What will replace it is unclear, but a simplified regime more suited to companies with significant physical assets may be the ultimate end-game.

Energy regulators also want to introduce more licensing. There has been no Europe-wide licensing regime for energy trading, and individual Member States have taken differing views on whether licenses are required. To help identify who is active in the market and check their suitability, the Council of European Energy Regulators consulted in April on the introduction of a Europe-wide wholesale energy trading licensing and passport regime<sup>3</sup>. While this may sweep away local physical licensing requirements, it will not prevent energy companies from still having to consider the financial regulatory regime.

## ***What does all this mean for energy trading businesses?***

Over the next years, energy trading businesses in Europe should expect:

- tighter requirements governing the disclosure and use of information about their physical gas and power businesses;
- greater pressure to establish information barriers between trading and operational activities;
- greater potential for regulators to take enforcement action for insider trading both in commodity derivatives and gas and power markets;

- tighter regulation of energy exchanges and auction platforms, with tougher requirements to prevent market abuse and stronger market surveillance;
- that it becomes tougher for non-financial institutions to trade in commodity derivatives without requiring a license under MiFID;
- continuing debate about the appropriate capital regime for energy-group companies that fall within the scope of financial regulation;
- possible requirements to license energy trading activities with their home state energy regulator; and
- closer regulatory attention to market structure and barriers to entry (as financial and economic regulators work more closely together).

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- 1. Commission Regulation (EU) No 1031/2010
  - 2. ERGEG draft advice on the regulatory oversight of energy exchanges
  - 3. CEER draft advice on the introduction of a Europe-wide Energy Wholesale Trading Passport

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