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Financial Services Authority
Energy Market Participants
and Oil Market Participants;
a consultation on the interim
regulatory regime for EMPs

June 2001



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Copies of this Consultation Paper are available for download from our website – www.fsa.gov.uk

Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372. The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 17 July 2001.

You can send your response by electronic submission using the form on the FSA's website (at www.fsa.gov.uk/pubs/cp/cp96.html), by e-mail or in writing to the following:

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Enquiries regarding the need for authorisation should be directed to Melanie Keyes, Authorisation Enquiries, telephone 020 7676 4706.

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. The names of all respondents will be published.

1 Executive summary

- 1.1 This consultation paper sets out our (the FSA's) proposals for firms carrying out certain regulated activities in relation to the energy markets: the Energy Market Participants (EMPs) regime. This consultation paper will also be of interest to those doing business with EMPs.
- 1.2 The proposed regime is based upon the current Securities and Futures Authority (SFA) regime for Oil Market Participants (OMPs). The SFA has set up a parallel regime¹, for firms who transact regulated activities based on electricity, gas, oil, coal and certain other energy-related products. This paper explains how we will carry forward that regime after implementing the Financial Services and Markets Act. This paper explains our regulatory approach and sets out those parts of our Handbook of rules and guidance that will apply to EMPs and OMPs.
- 1.3 The EMP regime is a disapplication and modification of the requirements of our Handbook, to reflect the risks posed by these activities to our statutory objectives. We are committed to working with market participants to ensure that this disapplication of parts of the Handbook is balanced by high standards of controls and risk management. We will monitor activity within the energy markets to make sure that the EMP regime continues to be consistent with our objectives. If the grounds for the regime change, in terms of the nature of the market participants or the conduct and stability of those participants, then we will consider whether the regime remains appropriate.
- 1.4 The EMP and OMP regimes set out will apply for a limited period. We are committed to reviewing the structure and terms of these regimes in the light of how they allow us to meet our statutory objectives. This paper explains how we propose to develop the regime and seeks views on the appropriate regulatory framework in the longer term.

¹ Board Notice 585, published May 2001, attached as Annex F

- 1.5 The Regulated Activities Order (RAO)² sets out certain exclusions and this paper provides guidance on their application, in particular that of the risk management exclusions under Articles 19 and 23 of the RAO. This paper also gives some guidance for firms considering whether they need to seek FSA authorisation and on the authorisation process.
- 1.6 While there may be a retail interest in the efficiency and effectiveness of these markets on the part of consumers as purchasers of gas and electricity in the home, and of petrol on the garage forecourt, we do not consider our role under the Act to extend to protecting the public from price fluctuations or to ensuring continuity of supply. The gas and electricity markets are subject to the oversight of the Office of the Gas and Electricity Markets (Ofgem). This paper sets out how the FSA and Ofgem will continue to co-operate, seeking to ensure that both regulators efficiently and effectively meet their different statutory objectives whilst minimising duplication of effort and unnecessary cost for firms.

² The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)

2 Introduction and overview

Industry and regulatory background

- 2.1 The OMP regime was put in place after the implementation of the Financial Services Act 1986 (FSAct). Since then, the oil market has continued to develop with the increasing use of complex derivatives by participants. These have been used not only to meet physical demand and supply requirements, but also to take positions on future price movements. The privatisation of the electricity and gas industries, and consequent advent of competition, has created an environment which has led to those markets developing in a similar way. There is an increasing inter-relationship between the oil, gas and electricity markets and overlap between the participants in each. The development of sophisticated expertise by some companies has also led to the growth of advisory and management services. As these markets have developed over recent years, so markets in coal and weather derivatives have emerged. In due course, similar markets in greenhouse gas emissions allowances and tradable renewable energy credits may also emerge.
- 2.2 Under the existing regulatory structure, the treatment of energy market participants has varied from market to market.
- The oil industry, through the OMP regime, is subject to a light touch regime, through a limited application of the SFA rulebook.
 - Most electricity market participants are ‘permitted persons’ under the FSAct, which means that they are exempt persons in respect of dealing in investments as principal or agent for related entities. This status has not been carried over into the Financial Services & Markets Act 2000 (FiSMA) and some of these companies may require authorisation at N2 (the date we assume our full powers).
 - Most gas market activity is forward for physical delivery and is not regulated activity or is exempt business under the Gas Industry Exemption Order. Because of this, and with the availability of other exclusions under

the FSAct, very few participants in the gas market are authorised, although some are permitted persons. As the market develops, and derivatives are used more commonly, we expect that some companies will need to seek our authorisation.

Some other energy related business is exempt under an exemption order made under the FSAct; a similar order is expected to be made under FiSMA. There is a significant overlap between participants, especially between those companies engaged in gas and oil and those engaged in gas and electricity.

- 2.3 In developing our approach to these markets, we have benefited from the advice of a specialist practitioner group, established for this purpose. The group consists of representatives of Axia Energy, BP Amoco, Centrica, Dynegy, Edison Mission Energy, Enron, Innogy, PowerGen, TXU, Yorkshire Electricity, Clifford Chance, Hyde & Co and Ernst & Young. We are grateful to these practitioners for their help and will ask the group to meet again to consider responses to this consultation.

Regulatory position to N2

Oil Market Participants

- 2.4 The OMP regime will continue in its present form up to N2.

Energy Market Participants

- 2.5 As set out in Board Notice 585, the SFA has set up a parallel regime, the interim EMP regime, based on rule waivers for companies currently engaged in energy market investment activity for the period before N2. It is expected to be relevant to three groups of companies:
- companies not currently authorised or permitted which wish to carry out regulated activities in non-oil energy markets (generally expected to be the electricity and gas markets);
 - current permitted persons who wish to engage in such regulated activities outside the terms of their permission; and
 - current OMPs now wishing to engage in energy-related regulated activities outside the terms of the oil market regime.

The EMP regime will be structured differently to the OMP regime in the way that it takes effect as individual waivers of the SFA requirements. In its effect, however, it is largely the same modified application of the SFA rulebook as the existing OMP regime.

- 2.6 The electricity market changed significantly with the introduction of the New Electricity Trading Arrangements (NETA) for England and Wales, which reached the 'Go Live' stage of implementation on 27 March 2001. Under the previous Pool arrangements, the wholesale price for physical electricity was set through a central price-determination mechanism, rather than through bilateral negotiation. This meant that both generators and suppliers were driven to use financially-settled hedging trades in order to tailor their price requirements. The NETA reforms have removed this central price-determination mechanism and leave market participants free to negotiate bilaterally.
- 2.7 The regulatory framework can accommodate the implications of NETA in two ways. First, the SFA/FSA will consider applications by participants in the electricity market who are permitted persons under the FSAct, to extend the scope of their existing permissions where necessary to ensure that transactions under NETA are covered. We are required to consider such applications on a case by case basis, but we would not expect to raise any objections unless there are exceptional reasons for doing so. Second, companies who are not currently authorised or permitted persons should consider the nature of their business activities and the possible need for authorisation under the FSAct, using the interim EMP regime if appropriate.

Regulatory position from N2 for a limited period

Oil Market Participants

- 2.8 The continuation of the OMP regime has already been embodied in sections of the Handbook of Rules and Guidance published in earlier consultations, in particular:
- limits to the requirements for the approval of individuals in the Supervision Manual (SUP 10.1.21R and 10.1.22G) published in May 2001;
 - the disapplication of Chapter 3 of the Interim Prudential Sourcebook for Investment Firms (IPRU INV)³ and consequential amendments to the auditor's rules in SUP3;
 - reduced requirements in relation to compliance, financial and transaction reports (SUP 16.6, SUP 16.7 and SUP 17); and
 - the limited application of the Conduct of Business Sourcebook⁴ (COB 1.6.5R and 1.6.6R).

³ Policy statement, March 2001

⁴ Policy Statement, February 2001

This paper proposes no material change to the position of OMPs as set out in those documents. The purpose of this paper for OMP firms is to help them navigate the Handbook, as well as to invite comment on the form regulation should take in the longer term. A guide to application of the Handbook to OMPs is in Annex A, which includes references to the adjustments described in this section. OMPs will be able to apply to be EMPs and this would require an adjustment in their permission to carry out regulated activities; they would then lose their OMP status.

Energy Market Participants

- 2.9 From N2, we will maintain the split between an OMP regime and an EMP regime for a limited period. Where a firm is engaged in both oil and non-oil energy-related regulated activities, it falls into the category of EMP; the OMP regime is for firms engaged in oil-related regulated activity only. Further detail on how the EMP regime is applied is in the next section.
- 2.10 The EMP regime will be given effect by a combination of rule change and issuing to individual firms, on application, modifications to our Handbook. A model modification is attached at Annex D and proposed changes to Handbook text are in Annex E. The working of these documents is discussed in section 3 below. A guide to how the Handbook will apply to EMPs, assuming individual modifications are granted, is in Annex A.
- 2.11 We plan to set up a regime that does not stifle growth or innovation, yet is appropriate to the risks posed by these activities to our statutory objectives. There is some overlap between these markets and other areas we regulate, increasingly in terms of on-exchange activity. But these markets are still sufficiently self-contained that a differentiated regime is appropriate in view of the implications for market confidence.
- 2.12 We will monitor activity within the energy markets to make an ongoing assessment that the EMP regime continues to be consistent with our objectives. There are three areas where we have particular concerns.
- First, we recognise that these are, at present, ‘professional markets’, developed by and for physical producers and consumers and with no direct retail investor participation. The EMP regime is predicated upon this type of participation, since it is reasonable to assume that participants in such circumstances can safeguard their own interests. Elements of the regime, such as the disapplication of capital adequacy requirements and some customer dealing protections within the Conduct of Business Sourcebook (COB), would not be appropriate if that participation were to change.

- Second, the disapplication of capital adequacy requirements removes a buffer against the failure of firms, always assuming, of course, that such requirements would compel the firms to hold more capital than they otherwise would. For reasons explained below, we consider this to be an appropriate regulatory position, justified partly by the fact that the nature of the participants means that they can make their own credit assessments. But we recognise that this puts the burden onto others. The Principles, threshold conditions and systems and controls requirements in Block 1 of the Handbook will apply in full to EMPs as to other firms. Additionally, exchange members will be subject to exchange and, where relevant, clearing house rulebook requirements about risk management procedures, training and competence of staff and margining requirements. We will monitor these standards and seek to promote best practice. We note also that physical electricity market participants will, as participants in the balancing mechanism, have to pass a credit assessment and provide appropriate credit cover.
- Third, the disapplication of certain reporting requirements on firms means that we have less information on which to base our supervisory responsibilities. This is appropriate where the risks to our objectives are limited. However, if it becomes clear either that prevailing standards of market conduct fall below levels we consider to be acceptable, or market volatility is significantly higher than expected, those risks will be increased and the regulatory position will need to change accordingly.

2.13 While there may be a retail interest in the efficiency and effectiveness of these markets on the part of consumers as purchasers of gas and electricity in the home, and of petrol on the garage forecourt, we do not consider our role under the Act to extend to protecting the public from price fluctuations or to ensuring continuity of supply. For consumers of gas and electricity, ensuring continuity of supply is the role of Ofgem. Further detail on the role of Ofgem, and our interaction with Ofgem, is in part 5 below.

2.14 We believe that the increase in costs associated with these interim proposals, as far as they relate to changes to proposed rules, are of no more than minimal significance to the firms concerned. As a result, we have not carried out a full cost-benefit analysis. Further consideration of cost and benefits issues associated with these proposals is set out in Annex B. As explained below, it is likely that there will be changes to the regime applying to EMPs in the long term. In line with the requirements for us to be accountable and transparent in our actions, we will consult fully if and when any changes are proposed, including any necessary cost-benefit and competition analysis.

2.15 The proposals in this paper are, we believe, consistent with our objectives and the principles of good regulation. In particular, a separate category of EMPs will better allow us to use our regulatory resources in an efficient and

economic way. There is a fuller analysis of how this proposal complies with our objectives and principles of good regulation in Annex C.

Q1: Do you accept the arguments put forward for the creation of a regime restricted to energy-related regulated activities?

Q2: Do you agree with the way that the EMP regime is being put in place?

Longer term regulatory position

- 2.16 The EMP regime being implemented by the SFA and continued by the FSA, as explained in this paper, provides only an interim solution to the regulatory requirements of these markets. In due course, the EMP and OMP regimes will need to be reviewed. Issues include whether the regimes should be combined, given the overlap of participants and products. Section 4 of this paper raises some of the issues surrounding this long-term regime for consultation.
- 2.17 The long-term review will be implemented no earlier than one year after N2 and it may be appropriate to introduce it at the same time as the Integrated Prudential Sourcebook⁵. As explained above, however, if circumstances change so that we believe that the regime from N2 is no longer appropriate in view of the risks these markets pose to our objectives, we may carry out the review earlier. We intend to reconvene our practitioner group to consider the results of this consultation, possibly with amended membership to reflect the wider scope of the issues to be addressed in the longer term. The group will need to consider carefully the potential for competitive distortion of any eventual proposals.

⁵ To be published, June 2001

3 Regulatory Arrangements from N2

Application

- 3.1 The EMP regime is for those firms whose regulated activities are confined to natural gas, electricity, oil, coal, greenhouse gas emissions allowances, tradable renewable energy credits or weather derivatives. For some purposes, it can also apply to other firms in respect of their energy investment activities. It also contains restrictions on the type of the clients with which the firm transacts, and it is not available to firms which transact energy-related regulated activities with or for individuals. Where a firm's regulated activities are purely oil investment activities, it will be treated as an OMP and not an EMP. Where a firm engages in oil and other energy-related regulated activities, it will be an EMP. Where a firm is engaged in regulated activities not related to energy investments as defined, it cannot be an EMP although the partial disapplication of COB will be available to for its energy-related regulated activities.
- 3.2 We expect this scope of application will evolve and we recognise that traded markets are developing in other energy-related areas. Greenhouse gas emissions and renewable energy credit trading are included within the scope of the EMP regime. The wider role that trading can play in promoting environmentally-beneficial energy production is increasingly accepted and other markets may be promoted in the future. We will keep the scope of the EMP regime under review.
- 3.3 Certain parts of the EMP regime, most notably the limited application of the capital rules, are subject to more narrow application criteria. These are set out below.
- 3.4 A definition of EMP and related definitions are located in Annexes D and E and, in relation to the SFA regime, Annex F. These definitions have been adapted from the previously published definitions relating to the Oil Market Participant regime.

Q3: Do you agree with the scope of the EMP regime? Is it appropriate for your range of business?

Q4: Should the EMP regime apply also to renewables obligations and other environmentally friendly trading activities? Are there other areas which should be considered?

Q5: Do you believe that restricting the application of the EMP regime by type of client is appropriately tight?

Content

- 3.5 The EMP regime operates as a disapplication or modification of some of the requirements in the Handbook. Where no such disapplication or modification is provided, the requirements in the Handbook will apply to EMPs as they do to other firms. A summary of the applicable provisions in the Handbook is set out at Annex A to this paper. The key disapplications and modifications are similar to those which apply to the OMPs and are in four areas.

Approval of individuals (SUP10.1)

- 3.6 Whereas individuals in ‘significant influence functions’ require approval, this is limited for EMPs whose main business activities are not regulated business to those in ‘required functions’. This recognises that it would be inappropriate to seek the approval of individuals other than those performing certain functions relating to the regulated activities. This part of the regime will be reflected in the relevant provisions in the Supervision Manual.

Q6: Do you agree that restricting the requirement to register individuals in ‘significant influence functions’ is appropriate for EMPs?

Capital adequacy (IPRU(INV) 3)

- 3.7 There will be a limited application of the requirements of IPRU(INV). The capital rules apply in the OMP regime where business is conducted by a firm as member of an investment exchange entitled to trade with other members. This is an established SFA rule and reflected in IPRU(INV)⁶. We do not propose to change it. However, this rule would not allow EMPs to benefit from the disapplication of the detailed capital rules and also to play a full role in the New Electricity Trading Arrangements. NETA is based on participation in on-exchange activity as bringing transparency and liquidity to the electricity price formation process. But to simply omit this from the test for EMPs for disapplication of the capital rules would not, we believe, be appropriate. This is to ensure that OMPs and EMPs conducting on-exchange

⁶ IPRU 3-1A R

oil investment activity are treated equally and because this part of the test addresses the point at which OMPs' regulated activity poses a risk to the exchanges and the clearing house, and hence the clearest risk to our market confidence objective. For the risks to our objectives arising through EMPs' exchange activity, we therefore believe it is an appropriate counterbalance to strengthen other parts of the test.

- 3.8 In order to aid the development of the market we are prepared to grant a concession to disapply the capital rules in certain circumstances. But to protect other market participants and market confidence as a whole, we propose that the disapplication of capital rules for EMPs is only available to those meeting three conditions
- that it may not carry out regulated activities other than in relation to energy;
 - that its main business is the generation, production, storage, distribution and/or transmission of energy; and
 - that it does not engage in oil market activity as a member of an exchange who is under the rules of that exchange entitled to trade with other members.
- 3.9 Unlike the permitted person regime, these conditions will be assessed by looking at the firm as a legal entity alone, rather than looking at any group of companies of which it may be a part. This reflects the fact that the firm is operating in the market as a legal entity. Other companies will be contracting with that legal entity and not the group as a whole. While it has been suggested that this approach may have an impact on existing or proposed corporate structures, we consider that restricting the regime in the way proposed is the most prudent way to limit the risks posed by EMPs. Corporate structures should not prevent us from developing a policy we consider to be the most appropriate to meet the risks posed to our objectives.
- 3.10 It will be for us to interpret the 'main business' test when a firm applies for the modification. This interpretation will include consideration of both quantitative and qualitative measures.
- 3.11 Consequential amendments of the auditors' rules in SUP 3 will be made. These track the special treatment of OMPs, to which the capital rules do not apply.
- 3.12 Note that all firms – including EMPs and OMPs – will be subject to the threshold conditions for authorisation, as published with the Authorisation Manual⁷. These continuing requirements include the maintenance of adequate resources for the regulated activities being carried on.

⁷ CP63, August 2000

3.13 The integrity of the exchanges and the London Clearing House will continue to be protected by their credit procedures and their own margining or collateral arrangements.

Q7: What are the practical implications for firms that cannot benefit from the disapplication of the capital adequacy rules?

Q8: Do you think that the combination of exchange and clearing house credit and margining requirements, the threshold condition to maintain adequate resources and the self-disciplining nature of firms' credit risk management processes will, together, be sufficient to ensure the credit quality of these market participants?

Q9: Do you agree that the differentiation of the capital adequacy rules between oil and non-oil energy investments is an appropriate treatment for the reasons stated?

Conduct of business

3.14 There will be a limited application of COB, which sets out the requirements on authorised firms in their business relationships with customers. The application of COB is limited to reflect the nature of the business and the type of customer: we believe that even those who are customers, rather than market counterparties, will be professionals who do not need or expect all the protections provided by COB.

3.15 Where a firm other than an EMP is engaged in energy market activity as defined, such as an investment bank, it will benefit from the restricted application of COB for its energy market activity only. Again, this concession is based on the nature of the customer base likely to be involved in these markets. The disapplication will also have effect for certain ancillary purposes in respect of the same activity.

3.16 The requirements upon firms in their dealings with market counterparties are set out in the chapter on Inter-Professional Conduct (the IPC) in the Market Conduct Sourcebook⁸. The IPC applies in full to OMPs and EMPs as it does to other firms. Our earlier consultation on the IPC⁹ explained the possibility of including annexes on certain markets and although there are no plans to do so for the energy markets, we may revisit this in the future. Note that there was energy market participation on the practitioner group which assisted in formulating the IPC.

3.17 The existing Oil Market Participant Code of Conduct is not being carried forward in the FSA Handbook. The only significant additions it made to the standard SFA rulebook were on market conduct and manipulation. From N2,

⁸ CP83, February 2001

⁹ CP47, May 2000

we will have powers to combat market abuse across a range of activities and markets through the Code of Market Conduct¹⁰.

Q10: Do you agree that the professional nature of participants in these markets make the partial carve-out of COB appropriate for EMPs?

Reporting Requirements

- 3.18 The draft Supervision Manual published in May 2001 contains a number of special provisions for oil market participants, as well as the special rule relating to controlled functions mentioned above. They are:
- OMPs are not required to send us compliance reports to the FSA as mentioned in section SUP 16.6, as a result of the combined operation of rules 16.6.1R, 16.6.2R and 16.6.6R.
 - OMPs are not required to send us financial reports in line with section SUP 16.7, due to note (1) to 16.7.6R.
 - OMPs are not required to submit transaction reports under Chapter 17 of the Manual in relation to oil market activity.
- 3.19 The model modification¹¹ reproduces these special rules and applies them to EMPs.

The authorisation process and entry into the EMP and OMP regimes

- 3.20 The FiSMA and the Regulated Activities Order (RAO) set out the activities requiring our authorisation. Firms must satisfy themselves as to their need for authorisation. In the most general of terms, existing permitted persons at N2 may be unlikely to require authorisation from N2 provided they only enter into transactions involving derivatives as principal, or as agent for a group company or co-participant in a joint (commercial) enterprise, either:-
- (a) with or through authorised or exempt persons or certain overseas persons;
or
 - (b) for risk management purposes.

Any permitted person at N2 seeking to enter into transactions in energy investments for the purposes of speculation or of providing market liquidity is likely to need authorisation, unless he structures his affairs so as to ensure that he always deals with or through an authorised or exempt person or otherwise within applicable exclusions. Any permitted person seeking to extend his activities to providing services for persons other than group

¹⁰ Policy Statement The Code of Market Conduct, April 2001

¹¹ Attached in Annex D

companies or co-participants in a joint enterprise (e.g. by providing a risk management advisory, arranging or dealing service for such third parties) is likely to require authorisation.

- 3.21 Companies that require authorisation before N2 should apply to the SFA, as in Board Notice 585.
- 3.22 Companies which believe that they will require our authorisation at N2 should seek authorisation at least two months before N2 to ensure that the application process can be completed in time. They are, however, advised that our Corporate Authorisations department are keen to discuss in detail the nature or form of potential applications that companies are likely to make before that date. Corporate Authorisations would welcome comments on this, which should be addressed in writing to Stefan Brzezicki, Manager, Corporate Authorisations.
- 3.23 As applications for modifications cannot be grandfathered, companies applying before N2 to either the SFA or the FSA for authorisation at N2 will need to lodge a consent for modification when they apply. Companies applying for authorisation after N2 will need to apply for the modification with their applications.
- 3.24 Firms which are OMPs under the existing regulatory regime at N2 will automatically continue as OMPs after N2.
- 3.25 Firms which are subject to the SFA's interim EMP regime at N2 will be grandfathered into our EMP regime at N2. Applications for authorisation made to the SFA and not determined by N2 will be grandfathered into applications to us.

The new regulatory approach

- 3.26 As explained in 'A New Regulator for the New Millennium'¹² and 'Building the New Regulator'¹³, we are developing a new operating framework designed to identify the main risks to its statutory objectives and use our resources in a way that addresses those risks most effectively. Under this approach, the nature and intensity of our relationship with a particular firm will depend on an assessment of the risk the firm poses to the statutory objectives. The assessment will consist of two parts: an analysis of the impact that the behaviour of a particular firm may have on the achievement of our statutory objectives; and an assessment of the probability that particular risks will materialise. As a result of the risk assessment process, each institution will be put in one of four categories, A, B, C or D. This will determine the nature of our relationship with them. A firm in category A, for example, will have a

¹² January 2000

¹³ Progress Report 1 - December 2000

close and continuous relationship with us. It will have more frequent risk assessments and a relatively more intensive risk mitigation programme than a firm in category B or C. At the other end of the scale, category D firms will have no formal risk assessments.

- 3.27 By the nature of their regulated activities, we expect that most EMPs will tend to score at the lower range of both impact and probability. We also take into account that EMPs do not transact with individuals. The allocation of EMPs to lower categories will carry with it a lighter regulatory regime.
- 3.28 This cannot be guaranteed, however, and an EMP with regulated activities of sufficient size would be allocated to one of the higher impact categories, reflecting the substantial impact its actions have on market confidence. Moreover, the Market Conduct Sourcebook will apply to all firms and this will cover significant elements of our regulatory obligations in relation to market confidence.
- 3.29 Our new operating framework is still under development but, because we aim to ensure its resources are used where the risks to the objectives are high, there could be benefits to EMPs in the form of appropriately reduced supervision. This could mean fewer visits by our supervisory or specialist teams, fewer examinations by external auditors, fewer requests for information or some combination of these. EMPs will not be exempt from the sectoral reviews or thematic work that will in future replace much of the institution-specific work for lower-impact firms. But they will not be covered in the reviews or themes that have a particular retail focus.

Charges and fees

Compensation Scheme

- 3.30 We have set out our proposals for a single Financial Services Compensation Scheme in CP58¹⁴. It is proposed that the costs of funding the Scheme should be made up of base costs, namely the cost of running the Scheme if no claims are made to which all regulated firms will contribute, and default-related costs. Given the limitation on the types of client with which EMPs can transact, EMPs are unlikely to be able to transact with any person eligible for compensation under the Scheme. So, it is proposed that EMPs should contribute to base costs only. (They should not be completely exempt as the existence of the Scheme helps to maintain public confidence, so benefiting all firms). They should not be liable for additional calls on the Scheme to fund claims.

¹⁴ July 2000

Ombudsman Scheme

- 3.31 Under current proposals, in Policy Statement Complaints Handling Arrangements: Response on CP49¹⁵, only private individuals and small businesses with a turnover of £1 million or less will be able to make complaints to the Ombudsman. As few of these are likely to transact with an EMP, there is a strong case for EMPs being exempt from participation in and funding of the Ombudsman Scheme. Under the Scheme, there will be no blanket exemptions and it will be up to individual firms to apply for exclusion. Firms will have to certify to us on an individual basis that they do not do any business covered by the Compulsory Jurisdiction of the FOS with potentially eligible complainants.

Fees

- 3.32 As in CP79, and its predecessor CP56, the fee-raising arrangements we intend to operate when the Act takes effect are designed to ensure the fees we charge groups of fee-payers (known as ‘fee-blocks’) reflect the resources needed to mitigate the risks collectively posed by the regulated firms within each fee-block to our statutory objectives. We propose to group firms providing broadly similar products and services into such fee-blocks, each of which can be broadly distinguished from others in terms of the nature of the risks to our objectives that its members pose. We intend to plan and manage a separate annual funding requirement for each fee block. So, it is important that each fee-block is sufficiently large to be financially viable in future. We believe that EMPs and OMPs ought to be accommodated within the existing fee-block structure (as explained in CP79) and so do not propose to create a separate fee-block on their account.
- 3.33 Within the fee-block the fees of each individual fee-payer will be calculated according to the size of the activities they undertake that relate to the fee-block (i.e. their share of the tariff-base). In the case of EMPs and OMPs they are likely to fall in a fee-block where the tariff-base will be the number of approved persons in certain customer-facing controlled functions (as defined in the Supervision Manual¹⁶; note that ‘customer’ in this and other contexts is likely to include corporate counterparties). In this context, it is worth noting that the activities carried out by EMPs and OMPs are unlikely to require large numbers of persons to be approved.

¹⁵ December 2000

¹⁶ Policy Statement The Regulation of Approved Persons: Controlled Functions, February 2001

4 Long-term proposals

- 4.1 The present consultation only covers the changes that will take effect before and at N2 and we aim to consult with market participants on a longer-term regime for EMPs and OMPs in 2002. This longer-term regime may be different from that on which we are consulting now. The OMP regime, from which the EMP regime has been derived, has been in place for over a decade and, in that time, has worked effectively, but with risks to the FSA (and the SFA before it). The experience with supervising the OMP regime does, however, provide two reasons to support our belief that there should be a thorough review of both regimes within a reasonable time after N2.
- 4.2 The first reason is that the EMP and OMP regimes together represent a departure from the normal regulatory approach in that they are based upon looking through the regulated activity to the underlying asset class. As stated above, this has implications for the consistency of our approach and can be contrasted to the move away from looking through to asset class in the case of money market and foreign exchange business. The same activity carried out in the same way for the same reasons should in principle bear the same regulatory burden. However, this will not necessarily be the case where the regulatory burden depends on the underlying asset behind the investment. So it may be an appropriate time to review whether the regime should – and could – extend to all firms which are predominantly not involved in regulated activities, or whether a sufficiently ‘light-touch’ regime will in any case result from our risk based approach, making such a carve-out unnecessary.
- 4.3 The second reason is that the oil market has developed since the introduction of the OMP regime in a way that has highlighted inadequacies in its coverage. Most importantly, the OMP regime fails to differentiate between types of participant, encompassing firms dealing as principal and firms arranging deals in oil market investments. Given that the rationale for the regime is driven by the position of essentially industrial firms for which regulated activities are only a necessary corollary to the main business, the inclusion of firms whose business is that of arranger would appear to be an anomaly. An alternative

viewpoint is that it would be wrong to impose a greater regulatory burden on arrangers than on principals.

- 4.4 A further reason for review is that it may in any case be appropriate to revisit the application of our Handbook. There are a number of areas where ‘light touch’ regimes are being implemented – such as service companies¹⁷ and wholesale only deposit takers¹⁸ – and whilst there are differences between them, it may be possible to consider the scope for consistency. Additionally, it will be necessary to consider the nature of the regulatory requirements in the context of the supervisory approach developed as part of our risk based approach.
- 4.5 In terms of timing the introduction of a longer-term regime may be allied to the introduction of the Integrated Prudential Sourcebook in January 2004 and the route of rulebook harmonisation that it embodies. As we are presently undertaking work on this longer-term regime, the draft Integrated Prudential Sourcebook as published for consultation¹⁹ does not include anything that would apply specifically to EMPs/OMPs. Firms may therefore be interested to look at, and respond to, this consultation paper as it sets out our overall thinking on the prudential sourcebook, taking forward the work outlined in Consultation Paper 31: The FSA’s approach to setting prudential standards²⁰.
- 4.6 We are clearly mindful that being unable to give a clear indication of the substance or timing of a longer-term regime increases uncertainty for firms in developing their business. We will obviously take this into consideration when bringing forward the longer-term regime.

Q11: Do you think that there should, in the long-term, be a distinct regime restricted to energy-related regulated activities?

Q12: Should the OMP and EMP regimes be merged in due course? Are the market overlaps and similar dynamics appropriate for this?

Q13: If not, how would you suggest the regime be defined?

Q14: How should the regime differentiate in its application to arrangers?

Q15: Do you believe that the present regime, in terms of the reductions of the normal regulatory burden it comprises, is appropriate? What changes in application of the Handbook would you propose for the long-term regime?

¹⁷ CP55, June 2000

¹⁸ CP88, April 2001

¹⁹ To be published, June 2001

²⁰ CP31, November 1999

5 The role of Ofgem and its relationship with the FSA

- 5.1 Ofgem's responsibilities and duties are outlined in the Gas Act 1986 and the Electricity Act 1989 (both as amended most recently by the Utilities Act 2000). Ofgem's principal objective is to protect the interests of gas and electricity consumers by promoting effective competition wherever appropriate. The Gas Act 1986 and Electricity Act 1989 make it an offence to engage in certain activities relating to gas and electricity without a licence. The Secretary of State and Ofgem issue licences. Licences contain various conditions. Some conditions relate to the participation in the wholesale energy market. Ofgem ensures compliance with licence conditions and has enforcement powers given to it under the relevant acts.
- 5.2 Ofgem's regulatory powers encompass some but not all aspects of the trading environment. In particular, some conditions in generation, supply and shipper licences relate directly to behaviour in the wholesale markets. Ofgem additionally has concurrent powers with the Office of Fair Trading under the Competition Act 1998 which are intended to address anti-competitive behaviour.
- 5.3 Ofgem supports the application of FSA regulation to certain parts of electricity and gas markets. Ofgem view this as valuable in underpinning the development of orderly and liquid markets. Further, firms that are not licensed by Ofgem will be able to trade in wholesale gas and electricity markets.
- 5.4 We have developed a dialogue with Ofgem over a period of more than a year and intend to agree on the future co-operation between the two agencies in order to prevent undue duplication of effort by the involvement of more than one regulator. There may well be instances where behaviour by parties licensed by Ofgem or the Secretary of State is the subject of investigation by both Ofgem and FSA. In such an instance we shall not be pursuing the same statutory objectives. So it may be possible that a particular action by a licensed party is the subject of two separate enforcement actions. In conducting their investigations, we would seek to co-operate and communicate with each other.

Summary of proposed regime and list of source materials

1. The table below is a high level content summary of the FSA Handbook. It shows which sections of the Handbook will apply to EMPs.
2. The Handbook will contain all of our rules and guidance once the Act comes into force. Each module of the Handbook is subject to consultation in its own right. The FSA gets its rule making powers under FiSMA in June 2001. We will then formally make and issue final Handbook text and interested parties should keep aware of developments through our website.
3. This annex is designed to give a broad overview of the EMP regime as we propose it should work at and from N2. To understand the detail of the regime, and how we have analysed relevant costs and benefits, it will be necessary to refer to the separate modular consultations. The source materials for these are listed in the table below and can be found on our website.

| Block | Topic | Applicability to EMPs and OMPs | Source Materials |
|---------------------------------------|---|--|--|
| Block 1 – High Level Standards | General provisions | Will apply to EMPs and OMPs. | Policy Statement General Provisions, published April 2001. |
| | Principles for businesses. | Will apply to EMPs and OMPs, although note the partial disapplication for business with market counterparties. | Policy Statement: High Level Standards for Firms and Individuals, published February 2001. |
| | Threshold conditions. | Will apply to EMPs and OMPs. | Published with CP63: the Authorisation Manual in August 2000. |
| | Principles and code of practice for approved persons. | Will apply to approved persons working for EMPs and OMPs. | Policy Statement: High Level Standards for Firms and Individuals, published February 2001. |
| | Criteria for assessing the fitness and propriety of approved persons. | Will apply to approved persons working for EMPs and OMPs. | |
| | Senior management arrangements, systems and controls | Will apply to EMPs and OMPs. | |

| Block | Topic | Applicability to EMPs and OMPs | Source Materials |
|-------------------------------------|------------------------------------|--|---|
| Block 2 – Business Standards | Interim prudential sourcebook | <p>Capital requirements do not apply to OMPs, except where members of recognised or designated exchanges, under IPRU(INV) 3-1A R.</p> <p>Capital requirements do not apply to EMPs, by modification, subject to certain conditions set out in Annex D below.</p> | Policy Statement: The Interim Prudential Regime for Investment Firms, published March 2001. |
| | Conduct of business sourcebook | OMP and EMPs will be subject to a modified set of COB rules as set out in COB 1.6.5R and following. | Policy Statement: Conduct of Business Sourcebook, published February 2001. |
| | Market conduct sourcebook | <p>The Code of Market Conduct will apply to EMPs' and OMPs' activities.</p> <p>The Price Stabilising Rules will apply to EMPs and OMPs, although are likely to be of only marginal relevance to their business.</p> <p>The Chapter on Inter-Professionals Conduct will apply to EMPs and OMPs.</p> | <p>Policy Statement: Code of Market Conduct, published April 2001</p> <p>CP 78: The Price Stabilising Rules, December 2000.</p> <p>CP83: Inter-Professional Conduct, published February 2001.</p> |
| | Training and competence sourcebook | The commitments in TC1 will apply to EMPs and OMPs. Whether the more detailed requirements in TC2 apply will depend upon the type of activity carried out by the firm and individuals. It is likely that TC2 will not apply to persons dealing as principals, but firms should be aware of the final text of the sourcebook due to be published in May 2001. | <p>CP 34: The Training and Competence Sourcebook, published November 1999.</p> <p>CP60: Feedback Statement to CP34, the Training and Competence Sourcebook, published July 2000.</p> <p>Policy Statement 60: Feedback Statement to CP 60 – Training and Competence Sourcebook, published December 2000.</p> |
| | Money laundering sourcebook | Will apply to EMPs and OMPs. | Policy Statement: Money Laundering, the FSA's New Role, published January 2001. |

| Block | Topic | Applicability to EMPs and OMPs | Source Materials |
|---------------------------------------|------------------------|--|--|
| Block 3 – Regulatory Processes | Authorisation manual | This manual explains, in the form of guidance, our procedures for initial authorisation of firms and approval of individuals. It also contains guidance on how the permissions regime will work. EMPs and OMPs should be aware of this manual as a source of guidance and information. | Policy Statement: The Authorisation Manual, published May 2001. |
| | Supervision manual | <p>This manual explains, and contains provisions that relate to, how we will monitor firms for compliance with requirement imposed by or under the Act. Many provisions in it will apply to EMPs and OMPs and will be of relevance to their day to day activities. It also contains provisions on fees.</p> <p>SUP 16.6 (compliance reports) and SUP 16.7 (financial reports) are both disapplied for OMPs.</p> <p>SUP 17 (transaction reporting) does not apply to commodity transactions but, for the avoidance of doubt, is specifically disapplied from OMPs.</p> <p>The above concessions will be available to EMPs by way of individual modification.</p> <p>The section on Controlled Functions explains which individuals require approval. SUP10.1.21 limits this in respect of OMPs.</p> <p>SUP3 (auditors) contains special application rules relating to OMPs.</p> <p>These concessions will be broadened to include EMPs.</p> | <p>Policy Statement: The Supervision Manual, published May 2001.</p> <p>Policy Statement: The Regulation of Approved Persons: Controlled Functions, published February 2001.</p> |
| | Enforcement manual | This manual explains our enforcement and disciplinary powers. The explanation includes when and how our powers might be used and the right of firms and approved persons who become subject to enforcement or discipline. | Policy Statement: The Enforcement Manual, published May 2001. |
| | Decision Making Manual | This manual explains, in the form of guidance, our procedures for decision making. EMPs and OMPs should be aware of this manual as a source of guidance and information. | Policy Statement: The Decision Making Manual, published May 2001. |

| Block | Topic | Applicability to EMPs and OMPs | Source Materials |
|--------------------------|--------------|--|--|
| Block 4 - Redress | Complaints | All authorised firms will be subject to the compulsory jurisdiction of the financial ombudsman service. However, it is likely that few clients of EMPs and OMPs will include eligible complainants, as defined. Consequently, this sourcebook will not ordinarily be relevant to EMPs or OMPs. | Policy Statement on Complaint Handling Arrangements – a response to CP49, published December 2000. |
| | Compensation | All authorised firms will be subject to the Financial Services Compensation Scheme. However, it is likely that few clients of EMPs and OMPs will include eligible claimants, as defined. So this sourcebook will not ordinarily be relevant to EMPs or OMPs. | CP58: Financial Services Compensation Scheme Rules, published July 2000. |

Consideration of costs and benefits

1. The purpose of cost-benefit analysis (CBA) is to assess, in quantitative terms where possible and otherwise in qualitative terms, the economic costs and benefits of a proposed new policy. In proposing new rules (including amending rules such as in this Consultation Paper), we are required to publish a CBA unless we consider that, making the appropriate comparison, there will be no increase in costs, or that any increase in costs will be of minimal significance. The appropriate comparison in this instance requires a comparison between the overall position if the rules are made and the overall position if they are not made.
2. In the present case, if the proposed amendments are not made then EMPs would not enjoy concessionary treatment from N2 and the full costs of Handbook compliance would fall on them. If the proposed amending rules are made, then firms will pay lower compliance costs. This section of the paper seeks to show that other costs, such as the economic costs which might arise if there was a greater likelihood of the failure of a market participant, are largely unaffected by these proposals. As a result, we conclude that there will be no increase in costs, or a minimal increase in costs, arising from the proposed amendments to the Handbook, so no CBA is required in this case.
3. However, to allow those affected by these proposals to make informed comment, the following material sets out an outline of the costs and benefits arising from the proposed rules and modifications to the Handbook, as well as the costs and benefits that would be associated with other possible treatments of EMPs.
4. As explained, a CBA of a new regulatory proposal compares the new regulatory requirement with the previous one. In this case, the relevant requirements are those that are proposed to be in place from N2. But we have also taken into account the requirements applicable before the implementation of SFA Board Notice 585, as the proposals from N2 are largely a continuation of that interim EMP regime. Consideration of cost and

benefit issues is also complicated by the differing circumstances of firms before the implementation of these proposals: broad scope firms, permitted persons and persons previously outside authorisation.

5. We have addressed the costs (and other implications) and the benefits of the various realistic options in reaching our policy. The alternative options considered were:
 - a wider disapplication of the Handbook than proposed.
 - the EMP regime as proposed;
 - no concessionary treatment; and
 - an exact replication of the OMP regime;
6. As well as considering the implications for firms affected by these proposals, the following material will also consider the extent of the proposed scope of these options, i.e. which firms are able to use the concessionary treatment.
7. The position of existing OMPs is not considered further, as their position is materially unaltered by these proposals.

A wider disapplication of the Handbook

8. We do not believe that a wider disapplication of the requirements in the Handbook is appropriate. The regulated activities carried out by EMPs pose risks to our objectives, principally the market confidence objective. We do not believe that we would be able to carry out effective supervision of firms by providing a wider carve out of the Handbook. Nor do we believe that market forces on their own are likely to provide the level of controls that a regulator would impose, as firms would not adopt the controls necessary to cover the risks that their failure poses to the market as a whole.
9. From a competition standpoint, a wider disapplication of the Handbook would increase the competitive advantage EMPs enjoyed over broad scope firms unable to benefit from the elements of the disapplication which were not available because they were involved in regulated activities unconnected with energy markets. It would, however, place such EMPs on more level terms with those energy firms completely outside regulation. In practice, however, as explained above it is unlikely that the implications of a further disapplication would be significant.

The EMP regime as proposed

10. Our regulatory requirements bear in mind the nature of a firm's business and the risks they pose to our objectives. So even without these proposals, the regulatory burden on EMPs would be reduced by the limited risks they pose, most notably because they do not deal with private customers. There is, however, still a clear benefit to EMPs in these proposals in comparison to the requirements they would otherwise face as set out in the FSA's Handbook, which would apply if these proposals were not being made. There is also a benefit to firms generally from the imposition of regulatory requirements that provide security to the market as a whole that a firm's internal controls might not address. We have already explained why we believe that a wider disapplication of the Handbook is not appropriate. The regime as proposed does, we believe, reach the right balance in reduction of costs to firms and meeting our objectives.
11. The limitation in the application of COB and in the controlled functions requiring approval provide a saving in an administrative burden. For COB, the limited application reflects the professional nature of the market participants. For the controlled functions, the limited application is to avoid capturing individuals not relevant to the regulated activities. So the imposition of these requirements in full for EMPs would be inappropriate and so would bring a limited benefit in the context of our objectives.
12. The elements of COB which do apply to OMPs and EMPs include COB 7.15 (Non-Market-Price Transactions). These provisions were not included in the original consultation version of COB (CP45), but the consultation on the IPC (CP47) raised the question of whether they should apply to firms dealing with customers as well as to their dealings with market counterparties. The response to the consultation was that they should. These requirements contribute to the protection of customers, of firms and to market confidence and we believe should apply to OMPs and EMPs as well as other firms in their dealings with customers.
13. The disapplication of the capital rules is viewed by firms as a more significant issue for the firms involved. This is not necessarily in the absolute amount of capital in the firms, but in the difficulty in demonstrating that the capital is adequate under our reporting requirements because of the present structure of their balance sheets. EMPs are willing to trade amongst themselves, which is evidence that they consider their counterparties to be adequately capitalised, or capable of providing adequate credit support. The imposition of capital adequacy rules may therefore produce few benefits.
14. Firms not applying the capital rules do not have the resulting reporting requirements to the FSA; with the nature of this business, the firms' management information systems are likely to be producing information on a

basis quite different to that needed to meet our reporting requirements. So this saving may be significant in not having to adjust the capacity of current IT systems.

15. Firms which are currently permitted persons under the FSAct have, in practice, no formal regulatory requirements. The fact that some or all of these firms will require authorisation at N2, and so face a regulatory burden for the first time, is a consequence of FISMA and not an issue that we are required to address in a CBA. We have, however, discussed the costs of regulation that these firms will face under these proposals as EMPs with the practitioners group. On the basis of these discussions, we believe that the cost of regulation to these firms is minimal, as firms have tended to adopt for their own risk management purposes the type of control framework we require. The segregation of the trading business into front, middle and back offices; the implementation of written procedures; the creation of independent credit and compliance functions; and oversight by senior executives are all features which we have found to be common amongst current permitted persons likely to become EMPs at, or before, N2.
16. The proposed conditions for the disapplication of the capital rules are applied to a firm as a legal entity, rather than considering the business of the group of companies of which the firm may be a part. The reason for this is that where a group has already set up a trading subsidiary, the principle objections to capital adequacy requirements largely fall away and the application of the capital adequacy requirements should not be oppressive. The costs of setting up the subsidiary have already been borne, and the group may have done so for reasons other than meeting regulatory requirements. So pre-existing trading subsidiaries have the options of:
 - meeting our capital requirements, which as explained we believe are not inappropriate for trading companies;
 - carrying on business outside the perimeter by using brokers, which we recognise would impose costs and reduce flexibility in trading operations.
17. The argument that the imposition of capital requirements is not a proportionate regulatory response to EMPs, as the business is not predominantly regulated activity, falls away where the regulated activity has been placed in a trading subsidiary.
18. We accept that there are potential competition issues but do not believe that these will prove significant. The competition concern arises because the capital rules disapplication is not available to all firms active in the energy markets: to make it so widely available would not be consistent with the risks to our objectives posed by the wider group of firms. Where groups have set up a trading subsidiary, the imposition of the capital rules on the subsidiary should not be onerous and is appropriate to risks posed by these firms. Where

such trading subsidiaries will now be required to meet the capital adequacy requirements, this will improve market confidence in the way they are regarded by their counterparties as a credit risk. Firms which play a physical role in the market may be able to obtain the disapplication of the capital rules, but new entrants which wish to engage in trading before purchasing assets would not. Such new entrants would, however, have the option to structure their activities so as to use the exclusions and avoid the need for authorisation, for example by dealing only with or through authorised persons. We will continue to monitor the market for signs that our judgement on this is incorrect and are especially keen to receive comments on this issue.

No concessionary treatment

19. As has been explained, the structure of the balance sheets of some firms likely to be EMPs would make it difficult for them to meet our standard capital adequacy requirements. This would impose restructuring and capital costs on firms. Such firms would have had a limited range of choices.
 - They could place their regulated activity in a trading subsidiary. This would impose costs upon the firms in restructuring. This may also be seen as a negative move as regards credit risk for the market, as counterparties would not have recourse to group assets (although they could be bound in by credit support agreements, which are common practice in the market).
 - They could conduct their regulated activities through various limited exclusions in the RAO, such as by the use of brokers as intermediaries. This option is always open to firms as an alternative to seeking authorisation, but it does impose costs upon firms which would have to be considered against the costs of authorisation. Such a course would not reduce the positions held by firms and so would not address the question of what risks those positions posed to the system or to firms.
 - They could not engage in regulated activities, which would be a limitation on their business and would be likely to damage the viability of NETA by reducing the level of liquidity in the electricity market.
20. So the imposition of standard capital adequacy treatment would not necessarily be possible and would be likely to force firms to incur costs in finding a way to work round the requirements. It would provide similar levels of market confidence to the proposed route, but at a higher cost. We do not believe that it would be a proportionate response to the risks posed to our objectives to impose the full capital adequacy requirements upon firms. We recognise the characteristics of these markets and their participants as being similar to the oil market and the need to be as consistent as practicable with the pre-existing OMP regime.

21. In competition terms this option has advantages, in the sense that it imposes a burden equally on all market participants. However, the proposed disapplication is a concession to aid market development, which would be hindered by this option.

An exact replication of the OMP regime

22. The EMP regime is different to the OMP regime in one respect, the circumstances when the capital rules are to be disappplied. One option would be to precisely replicate the OMP regime. This would allow firms to meet authorisation requirements, but only so long as they did not carry out trading as members of an RIE or DIE. From our discussions with firms, it is clear that they see our capital rules as onerous and they would structure their activities in a way to avoid the need to comply with them if that was a realistic alternative. In this instance, firms would have the choice of:
- using platforms other than RIEs. Following the introduction of NETA, there are a number of competing ‘power exchanges’, only some of which are RIEs. This option would be likely to have the effect of moving the ‘exchange’ activities onto platforms which are not as closely supervised as RIEs.
 - trading OTC. This would damage the intentions of NETA in introducing transparency and liquidity to the price formation process.
 - trading on exchange through brokers. This would add transaction costs to the trading.
23. So the exact replication of the OMP regime would impose costs on firms and reduce their flexibility (especially in terms of choice of platform). Neither would be likely to be a severe hindrance to the EMPs themselves, as they would be unlikely as a consequence to engage in activity on RIEs in a form so as to cause the capital rules to apply, and the implications would be most severely felt by the RIEs. This course would be unlikely to produce the ‘benefit’ of reducing the positions the firms would take and so would do nothing to reduce the risks to our objectives.
24. Some of the competition implications of this option for firms would be the same as the proposed option. In addition, however, this option would be uncompetitive by preferring platforms which were not RIEs over those which were. It would also probably add to the costs of electricity by damaging the efficient workings of the market.

Statement of compatibility with the FSA's general duties and the principles of good regulation

1. The Act requires the FSA to satisfy itself that any requirements it imposes are consistent with both its statutory objectives and the principles of good regulation. This section explains why we believe that our proposals for EMPs for the period from N2 are compatible with our general duties under section 2 of the Act and the most appropriate way of meeting our objectives.

Statutory objectives

2. We believe that the EMP regime is compatible with its statutory objectives.

Market Confidence

3. The proposals would subject EMPs to a lighter regulatory burden, especially in relation to capital requirements. The market would, however, be subject to a greater degree of protection than would be found in a free market. Moreover, we believe that this would be achieved without imposing significant or disproportionate costs and so adds, overall, to market confidence. Activity on recognised investment exchanges is subject to the standard collateral and margining requirements, which protects the exchanges and the London Clearing House.

Consumer Protection

4. We have a duty to determine the level of protection for consumers bearing in mind the differing degrees of risk, experience, needs for information and the general principle that consumers should take responsibility for their own decisions. The EMP regime sets out a differentiated approach which bears in mind the professional nature of the clients with whom EMPs will undertake regulated activities.

Public Awareness

5. This paper sets out the limitations of our role and powers. We will be co-operating with Ofgem to ensure clear and efficient regulation of the gas and electricity markets. We will also work with Ofgem to build public awareness of our respective roles.

Reduction of Financial Crime

6. We believe the proposals will be broadly neutral in terms of impact on our financial crime objective.

The principles of good regulation

7. We believe that the EMP regime is compatible with our general duty to have regard to:
8. **The need to use its resources in the most efficient and economic way.** This proposal is consistent with the principle of economy and efficiency because it will help us to match our supervision more closely to the perception of risk. An EMP will tend to pose fewer risks to our objectives than other investment firms and our supervision can be tailored to reflect this.
9. **The responsibilities of those who manage the affairs of authorised persons.** Senior management responsibilities, as outlined in Block 1 of our Handbook, remain in force. We do not believe the EMP regime will have a material affect on the responsibilities of directors and senior management to ensure the proper management of their firms.
10. **A burden or restriction should be proportionate to its expected benefits.** The application of the EMP regime is restricted by type of business and client. Because of this, and for the reasons explained above, the risks to our objectives are small and so too are the potential benefits from regulation. We are being proportionate in applying only a light touch regulatory regime.
11. **The desirability of facilitating innovation in connection with regulated activities.** The EMP regime responds to developments in energy markets and seeks to anticipate further developments. We have worked with practitioners to ensure that the regime is structured so as to be able to meet the needs of the markets as they continue to develop, which includes the need to review and develop the regime after N2. The inclusion within this regime of regulated activities based upon weather derivatives or greenhouse emissions is an example: neither of these is currently a significant traded market, but may be in the future.
12. **The international character of financial services and the desirability of maintaining the competitive position of the United Kingdom.** A number of

American and continental European energy companies have set up European trading operations in London; these could be set up elsewhere if the UK's regulatory regime was seen as an obstruction to business. This is a sign of the existing competitiveness of the UK and these proposals are intended to improve this position further by developing an effective - but not onerous - regulatory framework. The regulatory requirements for energy trading vary from one country to another, even within the EU. We would expect these to be harmonised by EU legislation in due course.

13. **The need to minimise the adverse effects on competition that may arise from any exercise of its general functions.** We are aware that by imposing a lighter set of regulatory requirements on EMPs than on other firms engaged in the same markets, we can be accused of providing them with an unfair advantage. It will, however, be open to any firm to structure its business so as to minimise the risks they pose to our regulatory objectives and the regulatory requirements on that firm would reflect the extent to which it has done so. We do not believe that this different treatment, necessary to address the risks to our objectives, will significantly disadvantage groups using trading subsidiaries. We believe that the proposals provide the best response available to both secure market confidence and minimise adverse effects on competition.
14. **The desirability of facilitating competition between those who are subject to any form of regulation by the FSA.** If these proposals contribute to the attractiveness of the UK as a place to do business and more firms come to the UK as a result, competition will be enhanced and the reduction in regulatory requirements is a partial removal of a barrier to market entry. These proposals will provide firms with additional comfort that their counterparties are appropriately regulated and have controls in place. A result is that we can expect the 'playing field' to be levelled to a sufficient extent to ensure that competition can work well.

Compatibility with the duty of the FSA to act in a way which the FSA considers most appropriate for the purpose of meeting its regulatory objectives

15. The regulatory objective paramount in considering the regime post N2 for EMPs is that of market confidence. We believe that we have proposed the most appropriate of available policies because it most appropriately addresses the market confidence objective in respect of EMPs for the reasons set out in this Annex and Annex B. We are not seeking to impose costs disproportionate to the risks but believe that some regulation in this market is necessary.

Model modification

1. This Annex sets out the parts of the EMP regime which will be given effect to by modification the Handbook of rules and guidance granted to individual firms.

Modification of Handbook

Energy Market Participant

Power

1. This modification is made by the *FSA* under sections 148 and 250 of the *Act*.

Authorised person to whom this waiver applies

2. This modification applies to (*the firm*).

Note

In addition to the provisions of this modification, the following special application provisions in the *Handbook* will apply to the firm (because it is an *energy market participant*): COB 1.6.5R, 1.6.6G, 1.6.7R, 1.6.8R, 1.6.9G and 1.6.10R and SUP 3.1.2R, 3.2.4G, 10.1.21R and 10.1.22G.

Term

3. (1) This modification takes effect from the date of this notice.

(2) However, if the firm is not then an *energy market participant*, this modification takes effect only when the firm becomes one.

Note

If the firm is an *oil market participant* then this modification will not apply to it because the definition of *energy market participant* excludes an *oil market participant*. The following parts of the *Handbook* contain special provisions about what parts of the Handbook apply to an *oil market participant*: COB 1.6.5R, 1.6.6G, 1.6.7R, 1.6.8R, 1.6.9G and 1.6.10R, SUP 3.1.2R, 3.2.4G, 10.1.21R, 10.1.22G, 16.6.2R, 16.6.6R, 16.7.6R and 17.1.1R, and IPRU(INV) 3-1A.

(3) This modification ends:

- (a) when the firm first stops being an *energy market participant*; and
- (b) if (a) does not happen earlier, two years after the date of this notice.

Modification of Handbook – Capital requirements

[**Note:** This clause will not be inserted in modifications for firms that will not, at the time the modification will take effect, clearly satisfy the conditions set out in the clause. For these purposes the FSA will take into account the relative proportions of the firm's assets and revenues that are referable to the various parts of the firm's business, as well as to any other factor that the FSA considers is relevant to an assessment of the prudential risk presented by the firm.]

4. The *FSA* directs that, to the extent it consists of *modifiable rules*, the part of the *Handbook* mentioned in the table applies to the firm with the modifications shown.

Table

| Part of Handbook | Modification |
|--------------------|--|
| <i>IPRU(INV) 3</i> | <i>IPRU(INV) 3</i> does not apply to the firm if: (a) its main business consists of the generation, production, storage, distribution, and/or transmission of <i>energy</i> ; and |

| Part of Handbook | Modification |
|------------------|--|
| | (b) it does not engage in <i>oil market activity</i> as a member of a <i>recognised investment exchange</i> or <i>designated investment exchange</i> who is under the rules of that exchange entitled to trade with other members. |

Note

IPRU(INV) 3 will apply (to the extent it is otherwise applicable) unless the firm satisfies both of these requirements.

An *energy market participant* to which *IPRU(INV)* 3 does not apply is still subject to the requirement of *Principle* 4 to have adequate financial resources.

Modification of Handbook – Reporting requirements

5. The *FSA* directs that, to the extent it consists of *modifiable rules*, each part of the *Handbook* mentioned in the table applies to the firm with the modifications shown.

Table

| Part of Handbook | Modification |
|--------------------------------------|--|
| <i>SUP</i> 16.6 (Compliance reports) | Section 16.6 does not apply to the firm. |
| <i>SUP</i> 16.7 (Financial reports) | Section 16.7 does not apply to the firm. |
| <i>SUP</i> 17 (Transaction reports) | Chapter 17 does not apply to the firm in relation to its <i>energy market activity</i> . |

Interpretation

6. (1) Unless the contrary intention appears, interpretative provisions (including definitions) of the *Handbook* or the *Act* or any instrument made under the *Act* apply to this modification in the same way they apply to the *Handbook*, the *Act*, or that instrument, respectively.

Note

Defined terms in this modification (other than the term “the firm”) are italicised.

(2) For the purposes of this modification the following term is defined:

modifiable rules means *rules* that the *FSA* may under s. 148 of the *Act* (Modification or waiver of rules) direct are to apply to an *authorised person* with such modifications as may be specified in the direction;

Note

Terms that are defined in the *Handbook* and are particularly relevant to this modification are reproduced below. For the purposes of this modification, the definition of *oil market participant* includes paragraph (b) of the definition.

Definitions

| Definition title | Definition text |
|--|--|
| <i>Balancing and Settlement Code</i> | the document designated by the Secretary of State and adopted by the National Grid Company plc as the Balancing and Settlement Code as modified from time to time in accordance with the terms of the transmission licence granted under section 6(1)(b) of the Electricity Act 1989 in respect of England and Wales, or any subsequent similar instrument or arrangements. |
| <i>electricity</i> | (1) electricity in any form, including electricity as deliverable through the <i>Balancing and Settlement Code</i> ; (2) any right that relates to electricity, for example the right under a contract or otherwise to require a person to take any action in relation to electricity, including: (a) supplying electricity to any person or accepting supply of electricity; or (b) providing any information or notice in relation to electricity; or (c) making any payment in relation to the supply or non-supply, or acceptance or non-acceptance of supply, of electricity. |
| <i>energy</i> | coal, <i>natural gas</i> , and <i>electricity</i> (or any by-product or form of any of them) or <i>oil</i> . |
| <i>energy collective investment scheme</i> | a <i>collective investment scheme</i> , the property of which consists only of property which is <i>energy</i> , <i>energy investments</i> , <i>greenhouse gas emissions allowances</i> , <i>tradable renewable energy credits</i> or cash awaiting <i>investment</i> . |
| <i>energy investment</i> | any of the following: (a) a <i>unit</i> in an <i>energy collective investment scheme</i> ; (b) an <i>option</i> to acquire or dispose of an <i>energy investment</i> ; (c) a <i>future</i> or a <i>contract for differences</i> where the <i>commodity</i> or property of any other description in question is: (i) <i>energy</i> ; (ii) an <i>energy investment</i> ; (iii) a <i>greenhouse gas emissions allowance</i> ; or (iv) a <i>tradable renewable energy credit</i> ; (d) a <i>contract for differences</i> where the index or other factor in question is linked to or otherwise dependent upon fluctuations in the value or price of any of (c)(i) to (iv) (including any prices or charges in respect of imbalances under the <i>Network Code</i> or the <i>Balancing and Settlement Code</i>); |

| Definition title | Definition text |
|---|---|
| | <p>(e) a <i>weather derivative</i>;</p> <p>(f) a <i>greenhouse gas emissions allowance</i>, if it is a <i>specified investment</i>;</p> <p>(g) a <i>tradable renewable energy credit</i>, if it is a <i>specified investment</i>;</p> <p>(h) rights to and interests in anything which is an <i>energy investment</i>.</p> |
| <i>energy market activity</i> | <p>(a) any <i>regulated activity</i> relating to an <i>energy investment</i> or to <i>energy</i>;</p> <p>(b) <i>establishing, operating or winding up an energy collective investment scheme</i>.</p> |
| <i>energy market participant</i> | <p>a <i>firm</i> which is not an <i>oil market participant</i>:</p> <p>(a) which carries on <i>energy market activities</i> which in the <i>United Kingdom</i> are confined to either or both the following:</p> <p style="padding-left: 40px;">(i) the performance of management services for the participants in an <i>energy collective investment scheme</i> in which individuals do not participate, and other <i>energy market activities</i> which are performed in relation to any such <i>energy collective investment scheme</i>;</p> <p style="padding-left: 40px;">(ii) other <i>energy market activities</i> which:</p> <p style="padding-left: 80px;">(A) are the <i>executing of own account transactions</i> on any <i>recognised investment exchange</i> or <i>designated investment exchange</i>; or</p> <p style="padding-left: 80px;">(B) if they are not the <i>executing of transactions</i> on such exchanges, are performed in connection with or for persons who are not individuals; and</p> <p>(b) (except in <i>COB</i>) whose <i>permission</i> includes a <i>requirement</i> that the firm must not carry on any <i>designated investment business</i> other than that in the definition of <i>energy market participant</i>.</p> |
| <i>greenhouse gas emissions allowance</i> | <p>an allowance, licence, permit, right, note, unit, credit, asset or instrument (the "allowance") where:</p> <p>(a) the allowance confers or may result in a benefit or advantage to its holder or another person; and</p> <p>(b) the benefit or advantage is linked to the emission or non-emission of quantities of carbon dioxide or other greenhouse gases into the environment by the holder of the allowance or by another person.</p> |

| Definition title | Definition text |
|---|--|
| <i>natural gas</i> | <p>(1) natural gas in any form, including natural gas as deliverable through the <i>Network Code</i>; and</p> <p>(2) any right that relates to natural gas, for example the right under a contract or otherwise to require a person to take any action in relation to natural gas, including:</p> <ul style="list-style-type: none"> (a) delivering natural gas to any person or taking delivery of natural gas; (b) providing any information or notice in relation to natural gas; or (c) making any payment in relation to the delivery or non-delivery, or the taking or non-taking of delivery, of natural gas. |
| <i>Network Code</i> | the network code prepared by Transco plc in accordance with condition 7 of the public gas transporter licence granted or treated as granted to Transco plc under section 7(2) of the Gas Act 1986, as in force from time to time, and includes any subsequent similar instrument or arrangements. |
| <i>oil</i> | mineral oil of any description and petroleum gases, whether in liquid or vapour form, including products and derivatives of <i>oil</i> . |
| <i>oil collective investment scheme</i> | a <i>collective investment scheme</i> , the property of which consists only of property which is <i>oil</i> or an <i>oil investment</i> or cash awaiting <i>investment</i> . |
| <i>oil investment</i> | <p>any of the following:</p> <ul style="list-style-type: none"> (a) a <i>unit</i> in an <i>oil collective investment scheme</i>; (b) an <i>option</i> to acquire or dispose of an <i>oil investment</i>; (c) a <i>future</i> where the <i>commodity</i> in question is <i>oil</i>; (d) a <i>contract for differences</i> where the property in question is <i>oil</i> or an <i>oil investment</i> or the index or other factor in question is linked to or otherwise dependent upon fluctuations in the value or price of <i>oil</i> or any <i>oil investments</i>; (e) rights to and interests in anything which is an <i>oil investment</i>. |
| <i>oil market participant</i> | <p>a <i>firm</i>:</p> <ul style="list-style-type: none"> (a) which carries on <i>oil market activities</i>, which in the <i>United Kingdom</i> are confined to either or both the following: <ul style="list-style-type: none"> (i) the performance of management services for the participants in an <i>oil collective investment scheme</i> in which individuals do not participate, and other <i>oil market activities</i> which are performed in relation to any such <i>oil collective investment scheme</i>; (ii) other <i>oil market activities</i> which: <ul style="list-style-type: none"> (A) are the <i>executing</i> of <i>own account transactions</i> on any <i>recognised investment exchange</i> or <i>designated investment exchange</i>; or (B) if they are not the <i>executing</i> of transactions on such |

| Definition title | Definition text |
|---|---|
| | <p>exchanges, are performed in connection with or for persons who are not individuals; and</p> <p>(b) (except in <i>COB</i>) whose <i>permission</i> includes a <i>requirement</i> that the <i>firm</i> must not carry on any <i>designated investment business</i> other than that in (a).</p> |
| <i>oil market activity</i> | <p>(a) any <i>regulated activity</i> in relation to an <i>oil investment</i> or to <i>oil</i>;</p> <p>(b) <i>establishing, operating or winding up</i> an <i>oil collective investment scheme</i>.</p> |
| <i>own account transaction</i> | <p>a <i>transaction executed</i> or arranged by the <i>firm</i> for its own benefit or for the benefit of its <i>associate</i>.</p> |
| <i>tradable renewable energy credit</i> | <p>an allowance, licence, permit, right, note, unit, credit, asset or instrument (the "credit") where:</p> <p>(a) the credit confers or may result in a benefit or advantage to its holder or someone else; and</p> <p>(b) the benefit or advantage is linked to the supply, distribution or consumption of energy derived from renewable sources by the holder of the credit or by someone else.</p> |
| <i>weather derivative</i> | <p>a <i>contract for differences</i> where the index or other factor in question is a climatic variable.</p> |

Changes to draft or final text to implement the interim EMP regime

1. This Annex sets out the changes to draft or final text of the Handbook required to implement part of the interim EMP regime.
2. The purpose of the proposed changes to the Handbook is to implement those parts of the interim EMP regime, as described in this Consultation Paper, that cannot be implemented by way of individual modification, because the rules and/or guidance involved is not, or not entirely, made under a provision mentioned in s.148 and s.250 of the FiSMA, and is therefore not modifiable in its entirety.
3. Minor changes are proposed to provisions that are part of the OMP regime (already exposed as part of the Conduct of Business Sourcebook and Supervision Manual) to ensure consistency with the proposed EMP regime. For example, minor changes are proposed to the definitions of *oil market activity*, *oil market investment* and *oil market participant*, and COB 1.6.5 and 1.6.6 will be replaced by provisions giving more extensive relief in relation to certain dealings as principal.

Proposed Handbook Text relating to Energy Market Participants (EMPs)

The following draft provisions will replace the indicated provisions in the Conduct of Business Sourcebook and the Supervision Manual.

They contain the following types of provision, as identified by a letter in the margin:

R Rules (other than evidential provisions); these are shown in **bold**.

G Guidance.

The rules will be made under sections 59, 138, 247 and 248 of the *Act*.

The guidance will be made under section 157 of the *Act*.

Every *rule* made under section 138 of the *Act* applies with respect to the carrying on of *regulated activities* and other activities, unless the context requires otherwise.

References to the *Act* are to the Financial Services and Markets Act 2000 and the above is to be interpreted in accordance with the Handbook Glossary.

Defined terms are shown in *italics* and a glossary of the most important such terms appears at the end of the provisions. Defined terms not appearing in that glossary are defined in the glossary attached to the draft Supervision Manual and/or the draft Conduct of Business Sourcebook.

Proposed Handbook Text relating to Energy Market Participants (EMPs)

CHANGES TO COB 1

A.1 Replace title of COB 1.6 by:

1.6 Application to stock lending activity, corporate finance business, oil market activity and energy market activity

A.2 Replace COB 1.6.5R, 1.6.6R with the following:

1.6.5 R In respect of:

(1) **oil market activity** undertaken by an **oil market participant**; and

(2) **energy market activity** undertaken by an **energy market participant**;

only the provisions of **COB** listed in **COB 1.6.7R** apply.

1.6.6 G For the purposes of **COB** only, an **oil market participant** or an **energy market participant** qualifies as such even if it has **permission** to engage in **regulated activities** outside the oil or energy markets respectively, so long as its activities within those markets are confined to certain kinds: see the definitions of **oil market participant** and **energy market participant**.

1.6.7 R Table Provisions applied to oil market activity and energy market activity

This table belongs to **COB 1.6.5R**.

| COB | Subject |
|-----------|--|
| Chapter 1 | Application and general provisions |
| 2.1 | Clear, fair and not misleading |
| 2.3 | Reliance on and responsibility for others |
| 2.4 | Chinese walls |
| 2.5 | Exclusion of liability |
| Chapter 3 | Financial promotion |
| 4.1 | Client classification |
| 7.1 | Conflict of interest and material interest |
| 7.15 | Non-market-price transactions |
| 8.1 | Confirmation of transactions |
| Chapter 9 | Client assets |

1.6.8 R Despite **COB 1.6.5R**, if:

(1) a firm is:

(a) an **oil market participant** undertaking **oil market activity**; or

(b) an **energy market participant** undertaking **energy market activity**; and

(2) that activity:

(a) consists of **dealing in investments as principal**; and

(b) under article 16 of the **Regulated Activities Order** (Dealing in contractually based investments) would not be a **regulated activity** if the **firm** were not an **authorised person**;

then only the provisions of **COB** listed in **COB 1.6.10R** apply to that **firm** in relation to that activity.

1.6.9 G Article 16 of the **Regulated Activities Order** sets out an exclusion for **unauthorised persons** who **deal in investments as principal** in **contractually based investments**. The exclusion relates to dealings:

(1) with or through an **authorised person** or, in certain cases, an **exempt person**;
or

(2) in certain cases, through an office outside the **United Kingdom** maintained by a party to the transaction.

1.6.10 R Table Oil market activity and energy market activity: provisions applied to certain principal dealings with or through authorised persons etc.

This table belongs to 1.6.8R.

| COB | Subject |
|------------------|--|
| Chapter 1 | Application and general provisions |
| 2.4 | Chinese walls |
| 2.5 | Exclusion of liability |
| 3.11 | Unregulated collective investment schemes |
| 7.15 | Non-market-price transactions |
| Chapter 9 | Client assets |

B. Changes to SUP 3

B.1 Replace note 1 to SUP 3.1.2R with the following:

3.1.2 R Table

[table as presently drafted]

Note 1 = This note applies for an *oil market participant* to which *IPRU(INV) 3* does not apply and for an *energy market participant* to which *IPRU(INV) 3* does not apply. Only *SUP 3.1*, *SUP 3.2* and *SUP 3.7* are applicable to such a *firm* and only *SUP 3.1*, *SUP 3.2* and *SUP 3.8* are applicable to its auditor.

B.2 Replace SUP 3.2.4 G with the following:

3.2.4 G *SUP 3.1.1R* and *SUP 3.1.2R* limit the application of this chapter in relation to *authorised professional firms* and certain *oil market participants* and certain *energy market participants*. Such a *firm* is not required, under this chapter, to appoint an auditor. If such a *firm* appoints an auditor, for example, under the Companies Act 1985, *SUP 3.7* and *SUP 3.8* nevertheless apply to help the *FSA* discharge its functions under the *Act*.

C. Changes to SUP 10

C.1 Replace SUP 10.1.21R and 10.1.22G with the following:

REQUIREMENT

10.1.21 R The descriptions of *significant influence functions*, other than the *required functions*, do not extend to activities carried on by a *firm* whose principal purpose is to carry on activities other than *regulated activities* and which is:

- (1) an *oil market participant*;
- (2) a *service company*;
- (3) an *energy market participant*; or
- (4) a wholly owned *subsidiary* of:
 - (a) a local authority; or
 - (b) a *registered social landlord*.

10.1.22 G It will be a matter of fact in each case whether a *firm's* principal purpose is to carry on activities other than *regulated activities* having regard to all the circumstances, including in particular where the balance of the business lies. If a *firm* wishes to rely on *SUP 10.1.21R*, it should be in a position to demonstrate that its principal purpose is to carry on activities other than *regulated activities*.

Relevant definitions

Further changes may be made to these definitions, in particular to reflect changes in statutory instruments; to refine the drafting or remove technical flaws; and to correct errors in house style or typographical or grammatical mistakes.

| Definition title | Definition text |
|--|--|
| <i>Balancing and Settlement Code</i> | the document designated by the Secretary of State and adopted by the National Grid Company plc as the Balancing and Settlement Code as modified from time to time in accordance with the terms of the transmission licence granted under section 6(1)(b) of the Electricity Act 1989 in respect of England and Wales, or any subsequent similar instrument or arrangements. |
| <i>electricity</i> | <p>(1) electricity in any form, including electricity as deliverable through the <i>Balancing and Settlement Code</i>;</p> <p>(2) any right that relates to electricity, for example the right under a contract or otherwise to require a person to take any action in relation to electricity, including:</p> <ul style="list-style-type: none"> (a) supplying electricity to any person or accepting supply of electricity; or (b) providing any information or notice in relation to electricity; or (c) making any payment in relation to the supply or non-supply, or acceptance or non-acceptance of supply, of electricity. |
| <i>energy</i> | coal, <i>natural gas</i> , and <i>electricity</i> (or any by-product or form of any of them) or <i>oil</i> . |
| <i>energy collective investment scheme</i> | a <i>collective investment scheme</i> , the property of which consists only of property which is <i>energy</i> , <i>energy investments</i> , <i>greenhouse gas emissions allowances</i> , <i>tradable renewable energy credits</i> or cash awaiting investment. |
| <i>energy investment</i> | <p>any of the following:</p> <ul style="list-style-type: none"> (a) a <i>unit</i> in an <i>energy collective investment scheme</i>; (b) an <i>option</i> to acquire or dispose of an <i>energy investment</i>; (c) a <i>future</i> or a <i>contract for differences</i> where the <i>commodity</i> or property of any other description in question is: <ul style="list-style-type: none"> (i) <i>energy</i>; (ii) an <i>energy investment</i>; (iii) a <i>greenhouse gas emissions allowance</i>; or (iv) a <i>tradable renewable energy credit</i>; (d) a <i>contract for differences</i> where the index or other factor in question is linked to or otherwise dependent upon fluctuations in the value or price of any of (c)(i) to (iv) (including any prices or charges in respect of imbalances under the <i>Network Code</i> or the <i>Balancing and Settlement</i> |

| Definition title | Definition text |
|---|---|
| | <p><i>Code</i>);</p> <p>(e) a <i>weather derivative</i>;</p> <p>(f) a <i>greenhouse gas emissions allowance</i>, if it is a <i>specified investment</i>;</p> <p>(g) a <i>tradable renewable energy credit</i>, if it is a <i>specified investment</i>;</p> <p>(h) rights to and interests in anything which is an <i>energy investment</i>.</p> |
| <i>energy market activity</i> | <p>(a) any <i>regulated activity</i> relating to an <i>energy investment</i> or to <i>energy</i>;</p> <p>(b) <i>establishing, operating or winding up</i> an <i>energy collective investment scheme</i>.</p> |
| <i>energy market participant</i> | <p>a <i>firm</i> which is not an <i>oil market participant</i>:</p> <p>(a) which carries on <i>energy market activities</i> which in the <i>United Kingdom</i> are confined to either or both the following:</p> <p>(i) the performance of management services for the participants in an <i>energy collective investment scheme</i> in which individuals do not participate, and other <i>energy market activities</i> which are performed in relation to any such <i>energy collective investment scheme</i>;</p> <p>(ii) other <i>energy market activities</i> which:</p> <p>(A) are the <i>executing of own account transactions</i> on any <i>recognised investment exchange</i> or <i>designated investment exchange</i>; or</p> <p>(B) if they are not the <i>executing</i> of transactions on such exchanges, are performed in connection with or for persons who are not individuals; and</p> <p>(b) (except in <i>COB</i>) whose <i>permission</i> includes a <i>requirement</i> that the firm must not carry on any <i>designated investment business</i> other than that in the definition of <i>energy market participant</i>.</p> |
| <i>greenhouse gas emissions allowance</i> | <p>an allowance, licence, permit, right, note, unit, credit, asset or instrument (the "allowance") where:</p> <p>(a) the allowance confers or may result in a benefit or advantage to its holder or another person; and</p> <p>(b) the benefit or advantage is linked to the emission or non-emission of quantities of carbon dioxide or other greenhouse gases into the environment by the holder of the allowance or by another person.</p> |

| Definition title | Definition text |
|---|---|
| <i>natural gas</i> | <p>(1) natural gas in any form, including natural gas as deliverable through the <i>Network Code</i>; and</p> <p>(2) any right that relates to natural gas, for example the right under a contract or otherwise to require a person to take any action in relation to natural gas, including:</p> <ul style="list-style-type: none"> (a) delivering natural gas to any person or taking delivery of natural gas; (b) providing any information or notice in relation to natural gas; or (c) making any payment in relation to the delivery or non-delivery, or the taking or non-taking of delivery, of natural gas. |
| <i>Network Code</i> | the network code prepared by Transco plc in accordance with condition 7 of the public gas transporter licence granted or treated as granted to Transco plc under section 7(2) of the Gas Act 1986, as in force from time to time, and includes any subsequent similar instrument or arrangements. |
| <i>oil</i> | mineral oil of any description and petroleum gases, whether in liquid or vapour form, including products and derivatives of <i>oil</i> . |
| <i>oil collective investment scheme</i> | a <i>collective investment scheme</i> , the property of which consists only of property which is <i>oil</i> or an <i>oil investment</i> or cash awaiting <i>investment</i> . |
| <i>oil investment</i> | <p>any of the following:</p> <ul style="list-style-type: none"> (a) a <i>unit</i> in an <i>oil collective investment scheme</i>; (b) an <i>option</i> to acquire or dispose of an <i>oil investment</i>; (c) a <i>future</i> where the <i>commodity</i> in question is <i>oil</i>; (d) a <i>contract for differences</i> where the property in question is <i>oil</i> or an <i>oil investment</i> or the index or other factor in question is linked to or otherwise dependent upon fluctuations in the value or price of <i>oil</i> or any <i>oil investments</i>; (e) rights to and interests in anything which is an <i>oil investment</i>. |
| <i>oil market participant</i> | <p>a <i>firm</i>:</p> <ul style="list-style-type: none"> (a) which carries on <i>oil market activities</i>, which in the <i>United Kingdom</i> are confined to either or both the following: <ul style="list-style-type: none"> (i) the performance of management services for the participants in an <i>oil collective investment scheme</i> in which individuals do not participate, and other <i>oil market activities</i> which are performed in relation to any such <i>oil collective investment scheme</i>; (ii) other <i>oil market activities</i> which: <ul style="list-style-type: none"> (A) are the <i>executing of own account transactions</i> |

| Definition title | Definition text |
|---|---|
| | <p>on any <i>recognised investment exchange</i> or <i>designated investment exchange</i>; or</p> <p>(B) if they are not the <i>executing</i> of transactions on such exchanges, are performed in connection with or for persons who are not individuals; and</p> <p>(b) (except in <i>COB</i>) whose <i>permission</i> includes a <i>requirement</i> that the <i>firm</i> must not carry on any <i>designated investment business</i> other than that in (a).</p> |
| <i>oil market activity</i> | <p>(a) any <i>regulated activity</i> in relation to an <i>oil investment</i> or to <i>oil</i>;</p> <p>(b) <i>establishing, operating or winding up</i> an <i>oil collective investment scheme</i>.</p> |
| <i>own account transaction</i> | a transaction <i>executed</i> or arranged by the <i>firm</i> for its own benefit or for the benefit of its <i>associate</i> . |
| <i>tradable renewable energy credit</i> | <p>an allowance, licence, permit, right, note, unit, credit, asset or instrument (the "credit") where:</p> <p>(a) the credit confers or may result in a benefit or advantage to its holder or someone else; and</p> <p>(b) the benefit or advantage is linked to the supply, distribution or consumption of energy derived from renewable sources by the holder of the credit or by someone else.</p> |
| <i>weather derivative</i> | a <i>contract for differences</i> where the index or other factor in question is a climatic variable. |

SFA Board Notice 585 and draft waiver

THE SECURITIES AND FUTURES AUTHORITY



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BOARD NOTICE 585

**RULE
MODIFICATION**

18 May 2001

INTERIM REGIME FOR ENERGY MARKET INVESTMENT ACTIVITY

Introduction

The purpose of this Board Notice is to establish an interim Energy Market Participants Regime (“interim EMP Regime”) in the run up to N2¹. This interim EMP Regime will be based on the availability of modifications to the SFA Rule Book in line with the existing Oil Market Participants Regime (“OMP Regime”). FSA² is expecting to consult shortly on equivalent arrangements to take effect at N2.

Recent wider discussions that have taken place within SFA/FSA, between the energy industry and the regulators, and between SFA/FSA and Ofgem (which also has regulatory responsibilities in these markets) regarding the non-oil energy firms (mainly electricity firms and natural gas firms), have identified a number of significant issues that require attention. The SFA and FSA have embraced these issues and have concluded, pending a comprehensive review of energy market investment activity post-N2, that an interim regime for energy market participants is the appropriate solution. This regulatory environment would be similar in economic effect to the current OMP Regime, although different in legal structure for reasons that are made evident below.

Application

The interim EMP Regime will apply to firms carrying on certain regulated activities in relation to investments based upon *electricity, natural gas, coal, greenhouse gas emissions allowance and weather derivatives*. The interim regime has no implications for OMP firms that are restricted by the SFA to conducting investment business in *oil* markets only; these firms will continue within the present OMP Regime. The application criteria for the interim EMP Regime can be focused in terms of the ‘potential participants’ and the ‘business activity’ that will be applicable. In relation to ‘potential participants’, the following situations need to be considered for potential authorisation applications:

Cont’d/...

¹ the date when the substantive provisions of the *Financial Services and Markets Act 2000* (“FiSMA”) take effect.

² the Financial Services Authority.

- new firm that wants to conduct investment business in *energy* markets pre-N2;
- new firm that wants to conduct investment business in *energy* markets post-N2;
- existing firm whose Permitted Person status will disappear at N2 and wants to conduct investment business in *energy* markets post-N2;
- existing firm, which currently relies on the fact that it deals with a Permitted Person wants to conduct investment business in *energy* markets post-N2;
- an OMP firm that wishes to conduct investment business in *oil* markets as well as other *energy* markets. In other words, the interim regime will apply to firms which combine investment activity in *oil* markets with other *energy* markets.

In terms of ‘business activity’, the interim EMP Regime will be applicable to a firm whose involvement in *energy* investment markets is confined to:

- management of *energy collective investment schemes* in which individuals do not participate, and other ancillary activities; or
- other investment activities which are conducted on-exchange and on-own account (or on behalf of members of the same group or joint-enterprise), or are conducted off-exchange and on own account or on behalf of non-individuals.

If the above-mentioned authorisation scenarios and business criteria are applicable, then the firm should refer to the remainder of the Board Notice to gain an understanding of the characteristics that define the interim EMP Regime. The Schedule to this Board Notice proposes the model form of modification of the SFA Rulebook that will implement this interim EMP Regime. The rule modifications will be available to a firm on individual application, from the date of this Board Notice.

Background

The interim EMP Regime will provide a way of regulating energy market investment firms that decide that they require SFA authorisation before N2; such firms are coming forward due to developments in the electricity and gas markets. As highlighted above, these firms may include “Permitted Persons” under paragraph 23 of Schedule 1 to the *Financial Services Act 1986* (“FS Act”) wishing to carry on energy market investments outside their scope of permission, and existing OMP firms that want to conduct investment business in non-oil energy market investments. It is, therefore, important to cover the basis on which the OMP Regime and the Permitted Persons Regime was built. The understanding of these regimes has helped to define the interim EMP Regime.

The OMP Regime

The “Oil Market Code of Conduct” (Appendix 2 to the SFA Rule Book) was designed by the Securities and Investments Board (“SIB”, now FSA) as part of a “light-touch” regime, run by the SFA. It lays down standards of conduct for (SFA) authorised OMP firms, but those standards do not have the force of law. The SFA understands that the Oil Market Code of Conduct will not be continued post-N2. The application rule for OMP firms [SFA Rule 1-11] provides the implementation of the “light-touch” regime. This Rule provides that in respect of the oil market investment activity of an oil market participant, only specified conduct of business rules in Chapter 5

of the SFA Rulebook apply. The financial rules in Chapter 3 apply to that activity, but only in respect of a member of a recognised or designated investment exchange who is, under the rules of that exchange, entitled to trade with other members. Further, the OMPs benefit from a partial waiver of the requirement under Rule 2-24 to register individual directors with no executive responsibility for the firm's investment business. This has been extended on a case-by-case basis.

The terms *oil market participant* and *oil market investment activity* are defined. Broadly, an *oil market participant* is a firm that conducts only certain kinds of oil market investment activity, and *oil market investment activity* is investment business which relates to *oil investments*. This last term includes oil investment futures, contracts for differences relating to oil, units in oil collective investment schemes, and options over or rights to and interests in oil investments.

The Permitted Persons Regime

Currently, the activities of some electricity and gas firms are excluded from the scope of the FS Act authorisation requirement. This was achieved via the status of "permission", which was generally made available to relevant firms at the discretion of the SIB. As such, these firms exist under the "Permitted Persons Regime" – Paragraph 23 of Schedule 1 to the FS Act. Generally, a "permission" is granted where the FSA is satisfied, for instance, that a company's investment business activities are peripheral to its main commercial business activities, and that the company generally confined its investment dealings to professional markets, and did not get involved with private investors. The Permitted Persons Regime will not be available under FiSMA, and no grandfathering arrangements are expected to be put in place specifically for Permitted Persons. Additionally, there are a number of other unauthorised energy trading firms who currently rely on the fact that they deal only with permitted persons.

The majority of the 38 existing Permitted Persons are non-oil energy firms. It is anticipated that some of these non-oil energy firms will require authorisation in order to conduct investment business post-N2 (although the precise number will depend on how firms view their need for authorisation in the light of the Regulated Activities Order under FiSMA). The treatment of these energy market participants post-N2 will be covered in a FSA Consultation Paper, which will be published soon. Issues arising out of the role of Ofgem – the gas and electricity regulator - will also be covered in the Consultation Paper.

The FSA has stated that it believes that prior to N2, the New Electricity Trading Arrangements ("NETA")³ can be accommodated within the existing Permitted Persons regulatory framework. The FSA will consider applications by participants in the electricity market who are Permitted Persons under the FS Act to extend the scope of their existing permissions where that may be necessary to ensure that transactions under NETA are covered. The FSA is bound to consider such applications on a case-by-case basis, but it has stated that it would not expect to raise any objections unless there are exceptional reasons for doing so.

Review of potential firms seeking authorisation for the interim EMP Regime

The SFA believes that an interim EMP Regime should be established before N2 to allow for timing issues that would be faced by firms who wish to be sure of being authorised at N2. Also, the FSA is unlikely to be empowered to consider applications for post-N2 authorisation more than a few months in advance of N2. Accordingly, the interim regime is designed to allow firms to apply to the SFA for

³ New Electricity Trading Arrangements for England and Wales that came into force on March 27th, 2001.

authorisation in good time before N2. Their authorisations will be grandfathered at N2 and those modifications are expected to be replaced by rule changes in the FSA Handbook to similar effect. The following is a review of potential firms that would be seeking authorisation for the interim EMP Regime:

- firms that are not currently authorised or permitted who wish to carry out investment business in non-oil energy markets will require authorisation for the interim regime;
- it is likely that some firms whose Permitted Persons status will disappear at N2 will need to be authorised to carry on regulated activities from N2. In addition, it is likely that some, at least, of the energy trading firms who currently rely on the fact that they deal with Permitted Persons will also require authorisation post-N2; and
- OMPs that wish to conduct non-oil energy market investment business are already authorised by the SFA to conduct investment business [only in oil investments]. Permitted Person status is not, as a matter of policy, granted to authorised persons. It is appropriate to extend the relief from conduct of business rules applied to those firms to other energy market activities they conduct.

Characteristics that define the interim EMP Regime

It is not considered appropriate to apply the full extent of the SFA Rulebook to EMP firms, since the characteristics of these firms are similar to those of OMP firms. Chief among the relevant characteristics which have led to this view include the absence of non-professional players, the strong “**caveat emptor**” ethos of the market and the high value of individual transactions. Also, there is the need in many of the transactions to be able to make or take, or arrange for another person to make or take, physical delivery of the underlying commodity. It is envisaged that the nature and extent of the interim EMP Regime would be similar to that which was initially envisaged by the SIB for the OMP Regime.

Legal form

The policy basis of the interim EMP Regime is expected to be the same both pre- and post-N2. Any differences in detail arise from differences between the SFA Rulebook and the FSA Handbook coming into effect at N2 and differences in the detail of the powers of the regulators. Before N2, the regime will be implemented by way of individually granted modifications to the SFA Rulebook.

After N2, the FSA envisages that the interim regime will partly be implemented by way of special rules in the Handbook, on the basis that not all of the relevant rules can be modified under FSA’s rule modification power, as will be further detailed in the FSA Consultation Paper. The balance of the provisions of the interim EMP Regime will be implemented by way of modifications granted after N2 or grandfathered modifications granted against the SFA Rule Book.

The proposed model form of modification of the SFA Rulebook, to implement this interim EMP Regime, is to be found in the Schedule to this Board Notice. However, it should be noted that each case will be treated on its merits. In particular, firms that already enjoy other waivers from the SFA Rule Book in relation to their oil market investment activity can expect an application for a similar waiver, in respect of wider energy market investment activities, to be favourably entertained.

Scope

Energy Market Participants

The regime will apply to *energy market participants*. This category will be defined in very similar terms to the term *oil market participant* in the current OMP Regime.

An energy market participant will be a person whose involvement in energy investment markets is confined to:

- management of *energy collective investment schemes* in which individuals do not participate, and other ancillary activities; or
- other investment activities which are conducted on-exchange and on-own account (or on behalf of members of the same group or joint-enterprise), or are conducted off-exchange and on own account or on behalf of non-individuals.

The types of energy products

As well as *oil* derivatives (including petroleum gas derivatives), most derivatives of *electricity*, coal, and *natural gas* will now be covered, as well as *greenhouse gas emissions allowance* and *weather derivatives*. As a result, an EMP firm granted a modification would be able to undertake oil market investment business and other energy market investment business within a “light-touch” regulatory regime. SFA recognises that, in time, other energy market products/investments may have developed for which the interim EMP Regime may have to be adapted.

Conduct of business requirements

The modification disappplies many conduct of business rules from energy market investment activity conducted by an energy market participant. The effect of the disapplication is to leave in place necessary general and procedural rules, while disapplying most rules concerned with the way a firm conducts its activities, in this case in the energy markets.

Financial requirements

The “light-touch” capital adequacy framework is available to an EMP firm on the condition that:

- it is not entitled, under Rule 2-19, to conduct any *regulated business* other than *energy market investment activity*;
- its main business consists of the generation, production, storage, distribution and/or transmission of *energy*]; and
- it does not engage in *oil market investment activity* as a member of a *recognised investment exchange* or *designated investment exchange* who is under the rules of that exchange entitled to trade with other members.

If a firm does not satisfy all three tests then the rules in Chapter 3 of the SFA Rule Book will apply.

Although the SFA inevitably retains assessment of financial resources as part of the fit and proper test on authorisation, the “light-touch” capital regime takes into account the “**caveat emptor**” ethos of the market and the nature of the relevant participants.

Client assets requirements

The client money and custody rules will not apply to the energy market investment activity of an energy market participant. Supervisory reviews of OMP firms indicate that client money is not held in these markets.

Registration of directors

EMPs will not be required to seek individual registration of directors who have no executive responsibility for the firm's investment business. This is in line with waivers currently granted to OMPs.

Other requirements

The modifications provide that, subject to the above, the *Membership Rules*, *Complaints and Arbitration Rules*, and *Enforcement Rules* will continue to apply to EMPs.

The basis for rule modifications

The overall effect of the EMP Regime is to create a "light-touch" regime where most of the regulatory requirements are disapplied (apart from the rules that do apply as highlighted in the Schedule to this Board Notice). SFA considers that compliance with a comprehensive regime (or with all the regulatory requirements) would be unduly burdensome on an EMP firm having regard to the benefit which compliance would confer on investors. Again, it is stressed that the modifications require that there are no individual clients, and no on-exchange dealings for customers involved. Where a firm conducts energy market investment activity on-exchange for customers or off-exchange with or for individuals, the interim regime will not apply. The SFA will also, naturally, take into account the circumstances of each case in deciding whether to make the modification available in particular instances. In addition, as indicated above, the SFA will consider any other existing waivers applying to a firm's oil investment business to its energy investment business.

Effective date

Rule modifications detailed in this document are available on individual application, from the date of this Board Notice. Each individual modification will specify the date on which it becomes effective.

Questions

A firm wishing to take advantage of this modified regime should do so in writing setting out how it meets the requirements set out in this Board Notice. The firm should send this to:

- its Supervisor if it is an existing [OMP] authorised firm; or
- to Stefan Brzezicki in Corporate Authorisations (020 7676 4550) and/or to Melanie Keyes in Authorisation Enquiries (020 7676 4706) if it is an applicant or potential applicant firm.

Any questions regarding the contents of this Board Notice should be directed to Usman Butt in the Conduct of Business Standards Division on Tel: 020 7676 5650.

BY ORDER OF THE BOARD
LYNDA BLACKWELL
SECRETARY

Model rule modifications of the OMP Regime to give effect, in general, to the EMP Regime and, in particular, to energy investments and energy market investment activities

**MODIFICATION OF SFA RULEBOOK
ENERGY MARKET PARTICIPANT**

Power

1. This modification is made by *SFA* under Rule 1-5 of the *rules of SFA*.

Person to whom modification applies

2. This modification applies to (*the firm*).

Term

3. (1) This modification takes effect from the date of this notice.

(2) However, if the firm is not then an *energy market participant*, this modification takes effect only when the firm becomes one.

(3) This modification does not apply to the firm while it is an *oil market participant* that is not entitled, under Rule 2-19, to conduct any *regulated business* other than *oil market investment activity*.

Note

Where this modification does not apply because of (3), Rule 1-11 applies to *investment business* conducted by the firm, and sets out what *rules of SFA* apply.

(4) This modification ends:

(a) when the firm first stops being an *energy market participant* after this modification takes effect; and

(b) if (a) does not happen earlier, two years after the date of this notice.

Note

The *FSA* has announced (see the *FSA* publication Grandfathering of Waivers (December 2000), and the proposed (as at March 2001) Consultation Paper and Policy Statement) its intention to introduce time limits on modifications given by the *SFA* and which are continued in effect or “grandfathered” on the commencement of the *new Act*. (4) must be read subject to those time limits.

(5) Subject to (4), to the extent that a provision of this modification is substantially reproduced in a rule taking effect under the *new Act*, that provision of this modification ends when that rule takes effect.

Modification – Conduct of Business Rules

4. Subject to 5, 6 and 7 below, where the firm is carrying on an *energy market investment activity*, the *rules of SFA* are modified so that only the following *rules of SFA* will apply to that activity –

(a) the *Principles* and any code or standard endorsed by *FSA* under *Principle 3*;

Note

SFA notes the Oil Market Code of Conduct issued by the *FSA* as guidance as to the *SIB*'s view on what constitutes proper conduct in the oil markets. The code is set out in **Appendix 2** to the *SFA* rulebook.

(b) the *General Rules*, where relevant, other than Rule 1-11;

Note

Rule 1-11 sets out an application rule for *oil market participants*. It is disapplied because this modification sets out a similar regime for the firm.

(c) the *Membership Rules*, where relevant;

Note

6 below deals specifically with Rule 2-24.

(d) the *Conduct of Business Rules* in the table below.

TABLE– Application of *Conduct of Business Rules* to energy market participants

| Rule | Subject |
|--|---|
| 5-1, other than rule 5-1(1)(d) in so far as it refers to paragraph 17(4) of Schedule 1 to the <i>Act</i> Note Where this modification applies, Rule 5-1(1)(d) applies to paragraphs 17(1)-(3) of Schedule 1 to the <i>Act</i> only in relation to the <i>Conduct of Business Rules</i> referred to in this Table. | application of <i>conduct of business rules</i> |
| 5-2 | reliance on others |
| 5-4 | <i>market counterparties</i> |
| 5-5 | classes of <i>customer</i> |
| 5-9 | <i>issue</i> and approval of advertisements |
| 5-10 | <i>issue</i> and approval of <i>direct offer advertisements</i> |
| 5-15(1) | fair and clear communications |
| 5-24 | <i>customers'</i> rights |
| 5-34(1),(12),(13),(14), and (15) | contract notes and confirmations |
| 5-36 | dealing ahead of publications |
| 5-51(1) | responsible behaviour in personal and other dealings |

- (e) the *Complaints and Arbitration Rules*;
- (f) the *Enforcement Rules*;
- (g) the *Commencement and Transitional Rules*, where relevant; and
- (h) the *Definitions*, where relevant.

Modification – Financial Rules

[**Note:** This clause will not be inserted in modifications for firms that will not, at the time the modification will take effect, clearly satisfy the conditions set out in the clause. For these purposes the SFA will take into account the relative proportions of the firm's assets and revenues that are referable to the various parts of the firm's business, as well as to any other factor that the SFA considers is relevant to an assessment of the prudential risk presented by the firm.]

5. The *Financial Rules* do not apply to the firm if:

- (a) it is not entitled, under Rule 2-19, to conduct any *regulated business* other than *energy market investment activity*;
- (b) its main business consists of the generation, production, storage, distribution and/or transmission of energy; and
- (c) it does not engage in *oil market investment activity* as a member of a *recognised investment exchange* or *designated investment exchange* who is under the rules of that exchange entitled to trade with other members.

Note

The *Financial Rules* will apply at a time unless, at that time, the firm satisfies all three of these requirements.

Modification – registration of directors

6. (1) Rule 2-24 is modified in its application to the firm so that a *director* that is not closely involved in the *energy market investment activity* of the firm is not required to become a *registered director* under the Rule, if the firm is not entitled, under Rule 2-19, to conduct any *regulated business* other than *energy market investment activity*.

(2) A *director* is closely involved in an activity if he is an executive director with managerial responsibility (whether sole or shared with other persons) for that activity.

Modification – General

7. The *rules of SFA* (other than the Rules (if any) specified in 5 above and Rule 7-17), do not apply to the firm, in respect of *energy market investment activity* which would have been excluded by paragraph 17(4) of Schedule 1 to the *Act*, but for the fact that the firm is an *authorised person*.

Interpretation

8. (1) Unless the contrary intention appears, interpretative provisions (including definitions) in the *rules of SFA* (or, unless the contrary intention appears, any part of the *rules of SFA*) or the *Act* apply to this modification.

Note

Defined terms (including terms defined in (3) below but not including the term “the firm”) in this modification are italicised.

(2) A reference to a Rule by a number is a reference to the *rule of SFA* of that number.

(3) For the purposes of this modification:

Balancing and Settlement Code means the document designated by the Secretary of State and adopted by the National Grid Company plc as the Balancing and Settlement Code as modified from time to time in accordance with the terms of the transmission licence granted pursuant to section 6(1)(b) of the Electricity Act 1989 in respect of England and Wales, and includes any subsequent similar instrument;

electricity includes—

(a) electricity as deliverable through the *Balancing and Settlement Code*; and

(b) any right that relates to electricity, for example the right under a contract or otherwise to require a person to take any action in relation to electricity, including supplying electricity to any person or accepting supply of electricity, or providing any information or notice in relation to electricity, or making any payment in relation to the supply or non-supply, or acceptance or non-acceptance of supply, of electricity;

energy means coal, *natural gas*, *electricity* (or any by-product or form of any of them) or *oil*;

energy collective investment scheme means a *collective investment scheme*, the property of which consists only of property which is *energy*, *energy investments*, *greenhouse gas emissions allowances*, *tradable renewable energy credits* and/or cash awaiting investment;

energy investment means any of the following—

(a) a unit in an *energy collective investment scheme*;

(b) an *option* to acquire or dispose of an *energy investment*;

(c) an *investment* falling within paragraph 8 of Schedule 1 to the *Act* (futures) where the commodity or property of any other description in question is *energy* or an *energy investment* or a *greenhouse gas emissions allowance* or a *tradable renewable energy credit*;

(d) an *investment* falling within paragraph 9 of Schedule 1 to the *Act* (contracts for differences etc.) where:

(i) the commodity or property of any other description in question is *energy* or an *energy investment* or a *greenhouse gas emissions allowance* or a *tradable renewable energy credit*; or

(ii) the index or other factor in question is linked to or otherwise dependent upon fluctuations in the value or price of *energy* (including any prices or charges in respect of imbalances under the *Network Code* or the *Balancing and Settlement Code*) or any *energy investment* or a *greenhouse gas emissions allowance* or a *tradable renewable energy credit*;

(e) a *weather derivative*;

(f) a *greenhouse gas emissions allowance* if it is an *investment*;

(g) a *tradable renewable energy credit* if it is an *investment*;

(h) rights to and interests in anything which is an *energy investment*;

energy market investment activity means any activity which falls within any of the paragraphs of Part II of Schedule 1 to the *Act* and is not excluded by Part III of that Schedule, but taking—

(a) references in that Schedule to *investments* as references only to *energy investments*; and

(b) paragraph 16 as relating only to *energy collective investment schemes*; and

energy market participant means a *firm* whose *energy market investment activities* in the United Kingdom are confined to either or both of the following—

(a) the performance of management services for the participants in an *energy collective investment scheme* in which individuals do not participate, and other *energy market investment activities* which are performed in relation to any such *energy collective investment scheme*;

(b) other *energy market investment activities* which—

(i) are the effecting of transactions on any *recognised investment exchange* or *designated investment exchange*, otherwise than to enable the firm to fulfil the *orders of customers* (except where:

(A) the firm and the *customer* are bodies corporate in the same *group* and the *customer* is acting as principal; or

(B) the firm and the *customer* are, or propose to become, participators in a joint enterprise with the firm and the transaction is or is to be entered into for the purposes of, or in connection with, that enterprise and the *customer* is acting as principal); or

(ii) if they are not the effecting of transactions on such *exchanges*, are performed in connection with or for persons who are not individuals;

greenhouse gas emissions allowance means an allowance, licence, permit, right, note, unit, credit, asset or instrument (in this definition, *the allowance*) where:

(a) the **allowance** confers or may result in a **benefit or advantage** to its holder or someone else; and

(b) the **benefit or advantage** is linked to the emission or non-emission of quantities of carbon dioxide or other greenhouse gases into the environment by the holder of the **allowance** or by someone else;

natural gas includes—

(a) natural gas as deliverable through the *Network Code*; and

(b) any right that relates to natural gas, for example the right under a contract or otherwise to require a person to take any action in relation to natural gas, including delivering natural gas to any person or taking delivery of natural gas, or providing any information or notice in relation to natural gas, or making any payment in relation to the delivery or non-delivery, or the taking or non-taking of delivery, of natural gas;

Network Code means the network code prepared by Transco plc in accordance with condition 7 of the public gas transporter licence granted or treated as granted to Transco plc under section 7(2) of the Gas Act 1986, as in force from time to time, and includes any subsequent similar instrument;

new Act means the Financial Services and Markets Act 2000;

tradable renewable energy credit means an allowance, licence, permit, right, note, unit, credit, asset or instrument (in this definition, *the credit*) where:

(a) the **credit** confers or may result in a **benefit or advantage** to its holder or someone else; and

(b) the **benefit or advantage** is linked to the supply, distribution or consumption of energy derived from renewable sources by the holder of the **credit** or by someone else;

weather derivative means an investment falling within paragraph 9 of Schedule 1 to the Act (contracts for differences etc.) where the index or other factor in question is a climatic variable.

Note

The *Definitions* in the *rules of SFA* contain the following definitions most relevant to this modification:

oil means mineral *oil* of any description and petroleum gases, whether in liquid or vapour form, and includes products and derivatives of *oil*;

oil collective investment scheme means a *collective investment scheme*, the property of which consists only of property which is *oil* or an *oil investment* or cash awaiting *investment*;

oil investment means any of the following—

(a) a unit in an *oil collective investment scheme*;

(b) an *option* to acquire or dispose of an *oil investment*;

(c) an *investment* falling within paragraph 8 of Schedule 1 to the *Act* where the commodity in question is *oil*;

(d) an *investment* falling within paragraph 9 of Schedule 1 to the *Act* where the property in question is *oil* or an *oil investment* or the index or other factor in question is linked to or otherwise dependent upon fluctuations in the value or price of *oil* or any *oil investments*;

(e) rights to and interests in anything which is an *oil investment*;

oil market investment activity means any activity which falls within any of the paragraphs of Part II of Schedule 1 to the *Act* and is not excluded by Part III of that Schedule, but taking—

(a) references in that Schedule to *investments* as references only to *oil investments*; and

(b) paragraph 16 as relating only to *oil collective investment schemes*; and

oil market participant means a *firm* whose *oil market investment activities* in the United Kingdom are confined to either or both of the following—

(a) the performance of management services for the participants in an *oil collective investment scheme* in which individuals do not participate, and other *oil market investment activities* which are performed in relation to any such *oil collective investment scheme*;

(b) other oil market investment activities which—

(i) are the effecting of transactions on any *recognised investment exchange* or *designated investment exchange*, otherwise than to enable the *firm* to fulfil the *orders of customers*; or

(ii) if they are not the effecting of transactions on such *exchanges*, are performed in connection with or for persons who are not individuals.

List of questions

- Q1: Do you accept the arguments put forward for the creation of a regime restricted to energy-related regulated activities?
- Q2: Do you agree with the way that the EMP regime is being put in place?
- Q3: Do you agree with the scope of the EMP regime? Is it appropriate for your range of business?
- Q4: Should the EMP regime apply also to renewables obligations and other environmentally friendly trading activities? Are there other areas which should be considered?
- Q5: Do you believe that restricting the application of the EMP regime by type of client is appropriately tight?
- Q6: Do you agree that restricting the requirement to register individuals in 'significant influence functions' is appropriate for EMPs?
- Q7: What are the practical implications for firms that cannot benefit from the disapplication of the capital adequacy rules?
- Q8: Do you think that the combination of exchange and clearing house credit and margining requirements, the threshold condition to maintain adequate resources and the self-disciplining nature of firms' credit risk management processes will, together, be sufficient to ensure the credit quality of these market participants?
- Q9: Do you agree that the differentiation of the capital adequacy rules between oil and non-oil energy investments is an appropriate treatment for the reasons stated?
- Q10: Do you agree that the professional nature of participants in these markets make the partial carve-out of COB appropriate for EMPs?
- Q11: Do you think that there should, in the long-term, be a distinct regime restricted to energy-related regulated activities?

Q12: Should the OMP and EMP regimes be merged in due course? Are the market overlaps and similar dynamics appropriate for this?

Q13: If not, how would you suggest the regime be defined?

Q14: How should the regime differentiate in its application to arrangers?

Q15: Do you believe that the present regime, in terms of the reductions of the normal regulatory burden it comprises, is appropriate? What changes in application of the Handbook would you propose for the long-term regime?

ISBN: 0117044350

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