

Market abuse

Basic principles

1. Part VIII of the FSMA enables the FSA to impose an unlimited financial penalty on a person or company if it is satisfied that they have or it has engaged in market abuse.

2. For behaviour to amount to market abuse, three tests must be satisfied:¹

(a) the behaviour must occur in relation to a ‘qualifying investment’ traded on a market to which section 118 of the FSMA applies;

(b) the behaviour must satisfy one or more of three conditions, ie:

(i) the behaviour must be based on information which is not generally available to those using the market but which, if available to a regular user of the market, would, or would be likely to, be regarded by him as relevant when deciding the terms on which transactions in investments of the kind in question should be effected;

(ii) the behaviour is likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments of the kind in question; and

(iii) a regular user of the market would, or would be likely to, regard the behaviour as behaviour which would, or would be likely to, distort the market in investments of the kind in question; and

(c) behaviour must be likely to be regarded by a regular user of the market who is aware of the behaviour as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.

3. The FSMA requires the FSA to issue a code containing such provisions as it considers will give appropriate guidance to those determining whether or not behaviour amounts to market abuse.² The FSA has, accordingly, issued a document entitled *The Code of Market Conduct* (the Code).

4. Some paragraphs in the Code describe behaviour that, in the opinion of the FSA, does not amount to market abuse. Under the terms of the FSMA, such behaviour is conclusively presumed as not amounting to market abuse.³ Other paragraphs in the Code may be relied upon so far as they indicate whether or not behaviour should be taken to amount to market abuse.⁴ The Code can, therefore, be regarded as supplementing the FSMA.

Qualifying investments traded on markets to which section 118 applies

5. As explained in paragraph 2(a) above, for behaviour to amount to market abuse it has to occur in relation to qualifying investments traded on markets to which section 118 applies.

6. The markets to which section 118 applies are referred to in the Code as ‘prescribed markets’. These include the IPE.⁵ None of the other prescribed markets are relevant for present purposes.

¹Section 118(1) and (2) of the FSMA.

²Section 119.

³Section 122(1).

⁴Section 122(2).

⁵By virtue of the Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001 (SI 2001/996).

7. ‘Qualifying investments’ are the investments set out in regulations 73 to 89 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.¹ These include (in broad terms):

- (a) contracts for futures unless made for commercial and not investment purposes (a contract is regarded as made for investment purposes if it is made or traded on a recognized investment exchange);
- (b) contracts for differences (excluding rights under a contract if the parties intend that the profit is to be secured or the loss is to be avoided by one or more of the parties taking delivery of any property to which the contract relates); and
- (c) options to acquire or dispose of a security or contractually-based investment (‘contractually-based investments’ is defined and the only kinds relevant for present purposes are those falling within (a) and (b) above and this subparagraph).

Behaviour

8. Behaviour to be regarded as occurring in relation to qualifying investments includes behaviour which:²

- (a) occurs in relation to anything which is the subject matter, or whose price or value is expressed by reference to the price or value, of those qualifying investments; and
- (b) occurs in relation to investments (whether qualifying or not and including any asset, right or liability) whose subject matter is those qualifying investments.

9. Accordingly, paragraph 1.3.1 of the Code states that behaviour coming within the scope of the market abuse regime includes:

- (a) dealing in qualified investments; and
- (b) dealing in commodities which are the subject matter of a qualifying investment (such a commodity is referred to in the Code as a ‘*relevant product*’).

10. Centrica pointed out that both spot and forward NBP transactions would be relevant products with respect to the IPE natural gas contract.

Misuse of information

11. As explained in paragraph 2, one kind of market abuse can arise where behaviour is based on information which is not generally available to those using the market but which, if available to a regular user of the market, would, or would be likely to, be regarded by him as relevant when deciding the terms on which transactions in investments of the kind in question should be effected.

12. Paragraph 1.4.11 of the Code explains the concept of relevant information. It refers, by way of example, to a case where a qualifying investment is a derivative relating to a commodity. It states that information or events affecting the deliverable supply of the commodity, such as information as to the business operations of major suppliers, would be relevant information.

13. Paragraph 1.4.4 of the Code sets out four conditions that need to be satisfied for behaviour to amount to market abuse on the basis of misuse of information where a person deals in a qualifying investment or relevant product:

- (a) the dealing must be based on information and the information must be one of the reasons for the dealing;

¹SI 2001/544. The Regulations are applied by the Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001 (SI 2001/996).

²Section 118(6) of the FSMA.

- (b) the information must be information which is not generally available;
- (c) the information must be likely to be regarded by a regular user as relevant when deciding the terms on which transactions in the investments of the kind in question should be effected; and
- (d) the information must relate to matters which the regular user would reasonably expect to be disclosed to users of the particular prescribed market.

14. The last point is further explained in paragraph 1.4.12 of the Code which states:

Information will only fall within MAR 1.4.4E(4) [ie (d) in paragraph 13] if it is either:

- (1) information which has to be disclosed in accordance with any legal or regulatory requirement (referred to as ‘disclosable information’); or
- (2) information which is routinely the subject of a public announcement although not subject to any formal disclosure requirement (referred to as ‘announceable information’).

15. The FSA told us that there are probably a few, but only a few, disclosable or announceable requirements in relation to IPE traded investments. There may be information that is disclosable as a regulatory requirement of, say, Ofgem that is relevant information in respect of IPE traded investments and that the regular user would reasonably expect market participants on the IPE to receive. The FSA could not, therefore, rule out the possibility of use of this information in relation to IPE traded investments amounting to market abuse.

16. The IPE told us that there were not any IPE requirements for information to be disclosed. So far as it was aware, the only items of information which were routinely the subject of a public announcement and relevant to a person trading on the IPE were loading programmes and planned maintenance of installations or refineries. These announcements were sent out by the terminal operators via news services such as Reuters and Dow Jones. The IPE required information from its members as to the size of positions of both the member’s proprietary account and of its various clients. This information was used by the IPE to assist in maintaining an orderly market but was restricted to the IPE Compliance Department and the FSA and not published or disclosed in any other way.

17. As regards the FSA’s comments about the regulatory requirements of Ofgem (see paragraph 15), there does not appear to be any class of information relevant to IPE transactions that would be disclosable information by virtue of Centrica’s licence.

18. Centrica told us that CSL made regular announcements to customers (which were reported by the trade press) regarding Rough’s operations. In many cases, it was required to do so by the SSC (which made the information disclosable). It gave the following as examples:

- planned maintenance outages;
- unplanned outages that resulted in cancellation days or force majeure;
- gross customer nominations;
- publication of the weighted average price of capacity sold; and
- interruption notices.

Centrica also said that other regular announcements regarding, for example, the percentage of capacity sold and forced purchases or sales due to operational problems might in some cases be regarded as announceable. Information on bookings at Rough was, however, never disclosed.

Centrica’s submission and discussion

19. Centrica submitted that if a person had information which was not available to persons trading in IPE natural gas futures contracts, but which would likely be regarded by such persons as relevant to

trading decisions in respect of such contracts (hence, being disclosable information), that person could commit market abuse by his trading activities or other behaviour, even if such behaviour did not involve that person in dealing in futures contracts on the IPE.

20. This submission is correct. A person with such information clearly could commit market abuse on the basis of misuse of information by his trading activities. The question is to what extent could Centrica use its knowledge acquired through ownership of Rough to its advantage without committing market abuse.

21. It is apparent from paragraphs 15 to 18 that CSL would be in possession of a considerable amount of information through its ownership of Rough that would be neither disclosable information nor announceable information but which Centrica could use in order to benefit its own trading operations directly or to help formulate competitive tactics vis-à-vis its downstream rivals. If Centrica used such information in this way it would be unlikely to be at risk of incurring a penalty for market abuse. We have in mind in particular the nominations made by individual customers for use of the capacity they had booked at Rough.

22. Centrica said that the SSC which was in force in relation to Rough for the current year required simultaneous disclosure of information to all signatories to the SSC and that information about Rough was protected from wider circulation within the Centrica group by the Centrica's own code of conduct. This may be so. However, in this appendix, we are concerned with what Centrica could do to its advantage without risk of penalty for market abuse. As it is open to Centrica to change the SSC for future sales and to change its Code, it would be possible for Centrica to use information to its advantage as set out in paragraph 21 without risk of penalty for market abuse. Whether it would be expected to do so is considered elsewhere in this report.

Distortion of the market

23. As explained in paragraph 2, behaviour can amount to market abuse where a regular user of the market would, or would be likely to, regard the behaviour as behaviour which would, or would be likely to, distort the market in investments of the kind in question.

24. Paragraph 1.6.4 of the FSA Code states that behaviour will amount to market abuse if the behaviour engaged in interferes with the proper operation of market forces with the purpose of positioning prices at a distorted level, and that this need not be the sole purpose but must be an 'actuating purpose'. 'Actuating purpose' is defined as 'a purpose which motivates or incites a person to act'.

Centrica's submission and discussion

25. Centrica submitted that the definition of 'market abuse' in Part VIII of the FSMA included 'distortion', ie behaviour which a regular market user would, or would be likely to, regard as being likely to distort the market in investments of the kind in question. Centrica said that the regime caught the use of agents and other procuring of market abuse. 'Behaviour' was not limited to dealing in the relevant investment on the prescribed market. Therefore, trading and supply activities in relation to natural gas would be behaviour that could amount to market abuse in relation to the market in the IPE natural gas futures contracts if those activities were likely to have a distorting effect on the market. In particular, exercising a supply squeeze (by, for example, withholding flexible gas) in order to drive prices higher on both the physical and derivative financial product markets could be market abuse.

26. Again the submission is correct. Clearly trading and supply activities in relation to natural gas would be behaviour that could amount to market abuse in relation to the market in the IPE natural gas futures contracts if those activities were likely to have a distorting effect on the market. Furthermore, exercising a supply squeeze (by, for example, withholding flexible gas) in order to drive prices higher on both the physical and derivative financial product markets clearly could be market abuse. However, as the submission recognizes, it would appear from the FSA code that such behaviour would generally need to be made for the purpose of affecting the derivative financial product market on the IPE for there to be a realistic risk of a penalty being incurred.

27. Centrica could squeeze the market for reasons other than interfering with the derivative markets on the IPE. It might do so in order to benefit from higher prices for Rough capacity, which tend to move

with summer/Q1 differential in gas prices, or from the higher retail prices. Whether it would in fact be to its benefit to proceed in this way is considered elsewhere in this report.

Directive 2003/6/EC of the European Parliament and of the Council

28. Centrica said that Directive 2003/6/EC on Insider Dealing and Market Manipulation needed to be implemented into English law by October 2004. Broadly, this Directive extends the current EC requirement for member states to prohibit¹ insider dealing to cover dealing in commodity derivatives based on inside information. It also prohibits ‘market manipulation’, which is widely defined and would extend to transactions effected otherwise than on a regulated market, but which give a false or misleading signal as to the demand for or price of financial instruments on a regulated market, or which secure the price of a financial instrument at an abnormal or artificial level. The IPE natural gas futures contracts would be financial instruments traded on a regulated market for this purpose.

29. This is a reasonable summary of the main provisions of the Directive. We do, however, have two points to add. First, the Directive provides that ‘insider information’ in relation to derivatives on commodities means information which (in addition to other requirements) users of markets on which the derivatives are traded would expect to receive in accordance with ‘accepted market practices’ on those markets.² ‘Accepted market practices’ is defined as practices that are reasonably expected in one or more financial markets and are accepted by the competent authority of the member state in accordance with guidelines issued by the European Commission.

30. Second, as stated by Centrica, the definition of ‘market manipulation’ includes transactions effected otherwise than on a regulated market, but which give a false or misleading signal as to the demand for or price of financial instruments on a regulated market, or which secure the price of a financial instrument at an abnormal or artificial level. However, there is an exception for cases where the person who entered into the transaction establishes that his reasons for so doing are legitimate and conform to ‘accepted market practices’ on the regulated market concerned.

31. It can be seen, therefore, that in relation to derivatives on commodities, the Directive is broadly in line with the market abuse approach of the FSMA (see paragraph 2). However, instead of the regular user tests it has a test based on ‘accepted market practices’, and these practices will have to be based on guidelines issued by the European Commission. It also reverses the burden of proof in some cases.

32. Accordingly, whilst we recognize that the Directive might lead to some tightening of the market abuse regime in relation to commodities, we do not see it as likely in practice to affect Centrica’s future conduct to any appreciable extent.

¹See Council Directive 89/592/EEC.

²The full definition is as follows: ‘In relation to derivatives on commodities, “inside information” shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more such derivatives and which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets.’