

Implications of REMIT for Energy Brokers

16 January 2012



What REMIT means for Energy Brokers

REMIT [Regulation on Energy Market Integrity and Transparency - 2010/0363 (COD)] is the furthest along and possibly the most significant of the new European regulations coming to the wholesale European energy markets. For energy brokers, REMIT will bring new regulatory burdens that will affect many parts of the brokers' organisations, starting on December 28th 2011. This paper examines the impact that REMIT will have, and discusses what Trayport® is doing to ensure that Trayport's products enable brokers to comply.

Introduction to REMIT

REMIT extends the framework that already exists in the securities industry for market abuse and insider trading. It is designed to complement and expand the scope of the Market Abuse Directive (MAD) to cover energy derivatives and emissions trading. It calls for firms to register with their national regulator and to provide detailed transaction records to the European Agency for the Cooperation of Energy Regulators (ACER).

At a high level, REMIT:

- **Requires all transactions and fundamental data to be reported to the new pan-European energy market supervisor ACER.** REMIT doesn't limit what ACER may ask for, but it is assumed that over time it will be a very broad set of economic, non-economic and reference data, including all trades and orders. Data will be shared with other regulators, such as ESMA and national regulators.
- **Prohibits trading on "inside information"**, which is broadly defined to be anything that will significantly influence the market price of any given wholesale energy product. Such information includes the capacity of facilities for production, storage, consumption or transmission of electricity or natural gas. Those possessing "inside information" must make it public and may not trade on it until it is in the public domain.
- **Prohibits "market manipulation" or attempting to do so**, which is again defined very broadly as entering into transactions, creating or removing orders, or distributing any other information to send false signals about the capacity, supply, or price of a wholesale energy product.
- **Requires brokers to notify national regulators without further delay of any transaction they suspect of having breached the rules prohibiting trading on inside information, the requirement to publish inside information, or the prohibition against market manipulation.**
- **Requires brokers to establish and maintain effective arrangements and procedures to identify breaches of rules prohibiting trading on inside information, the requirement to publish inside information, or the prohibition against market manipulation.** It's reasonable

to assume that an effective arrangement and procedure would require brokers to implement a surveillance system and the associated control procedures.

- **Establishes a register of all European Market Participants.** The contents of the register are at least initially known only by the national regulator, with some public disclosure of information that is not commercially sensitive.

REMIT has reached a significant milestone. In mid-October 2011, the European Union and Council formally adopted the regulation, which had been approved by the European Parliament in mid-September. REMIT will come into force on December 28th 2011 and compliance with the market abuse provisions is required from this date, while transaction reporting compliance will likely be mandatory sometime in the first half of 2013.

Transaction Reporting

It's clear from the REMIT regulation that market participants trading wholesale European energy contracts must report their transactions to ACER. However, as no suitable reporting mechanism currently exists within the marketplace, the question is, how will this reporting obligation be fulfilled?

If REMIT was the only piece of European regulation coming to the European Wholesale Energy Markets, the path forward would be relatively predictable with all transactions being reported directly to ACER. However, this is not the case. Following on the heels of REMIT there are two pieces of financial regulation with reporting implications that currently include commodity derivatives in their scope—the MiFID/MiFIR Review [European Market Infrastructure Regulation – 2010/0250(COD)] and EMIR [European Market Infrastructure Regulation – 2010/0250(COD)] .

This means that there are three mechanisms market participants could potentially use to meet their reporting obligations. They include:

- Reporting transactions to ACER under the REMIT obligations;
- Reporting transactions directly to a national regulator under the MiFID/MiFIR obligations; or
- Reporting transactions to a Trade Repository under the EMIR obligations

In fact, REMIT explicitly provides for this with Article 7.2, which states that reporting under EMIR or MiFID/MiFIR will meet the market participant's obligation.

By driving down the complexity and costs of complying with future European legislation, Trayport's aim is to ensure that for anyone on the Trayport software network, compliance should not be a barrier to participation in the energy markets.

Trayport estimates that €80-100m is spent annually in Europe by companies processing trade information solely for their own purposes and this figure could increase under the new regulation. Trayport, with its clients, is looking at how the execution and order routing systems it supplies can be enhanced to deliver standard trade information at source that is compatible

with the requirements of new legislation and to reduce this figure significantly, including trade reporting services.

Market Surveillance

REMIT recognises that individual brokers have limited capacity to detect market abuse because trading participants typically trade across a range of brokers and exchanges. For example, a trader engaging in price manipulation could buy via one broker and sell via another, limiting either broker's attempts to detect the abuse. This same limitation exists at a national level, with the advanced state of development of the single integrated European power and gas market. Only a regulator with a view of the entire market and a full data set that reflects this position can reliably detect abuse; for this reason ACER will take on primary responsibility for market surveillance.

Nevertheless, Article 10 (3) of REMIT requires "Persons professionally arranging transactions in wholesale energy products shall establish and maintain effective arrangements and procedures to identify breaches of the provisions of Articles 3[Prohibition of insider trading and obligation to publish inside information] or 4[Prohibition of market manipulation]."

This requirement raises many questions for brokers. For example, what regulators will consider effective arrangements and procedures for detecting trading on inside information or market manipulation?

Examples of the forms of market manipulation that brokers may be expected to detect include:

- **Circular Trading:** several traders collaborating to buy and sell amongst themselves in a circular fashion, to create the illusion of large trading volumes.
- **Drop & Corner:** making several small sells (thus pushing the price down) and then buying big.

To fulfil the regulatory requirement for such surveillance, brokers should consider implementing a market surveillance system that can automatically monitor the market for this type of abuse and alert compliance officers. In addition to alerts, typical surveillance solutions offer market-replay functionality to enable compliance officers to review the state of the market at the time of suspected abuse. Many surveillance systems also offer a case-management facility to enable officers to store and organise material related to each investigation.

Trayport is currently working with established vendors of surveillance systems, to offer brokers a surveillance solution that will be fully integrated with Trayport's Broker Trading SystemSM product.

Data Quality

Transaction reporting and market surveillance both require a foundation of high-quality data. Ensuring data quality can be a challenge. Indeed, in the investment banking world under the current MiFID Transaction Reporting obligations, the majority of fines that have been issued by the FSA are a result of poor data integrity and data quality, alongside underdeveloped control frameworks.

At most brokers, transaction data typically originates from many integrated systems within the broker’s front and back offices. In this complex environment, brokers looking to ensure the quality of their data should consider:

- **Identifying the “Golden Source”:** which system should be the golden source of transaction data and reference data?
- **Validation:** brokers should look to validate data as close to the point of input as possible.
- **Filtering:** to ensure data is not omitted, filtering should be based on suppression logic rather than inclusion logic. This means that there is a common complete data set that is available to all market participants rather than having data made up from various contributors depending on various circumstances. Having one common complete dataset will provide certainty and reduce risk to the participants.

To ensure ongoing compliance, brokers should look to implement a data assurance framework. Figure 1 shows how the above points could fit into an assurance process covering the full front-to-back lifecycle of the transaction reporting process.

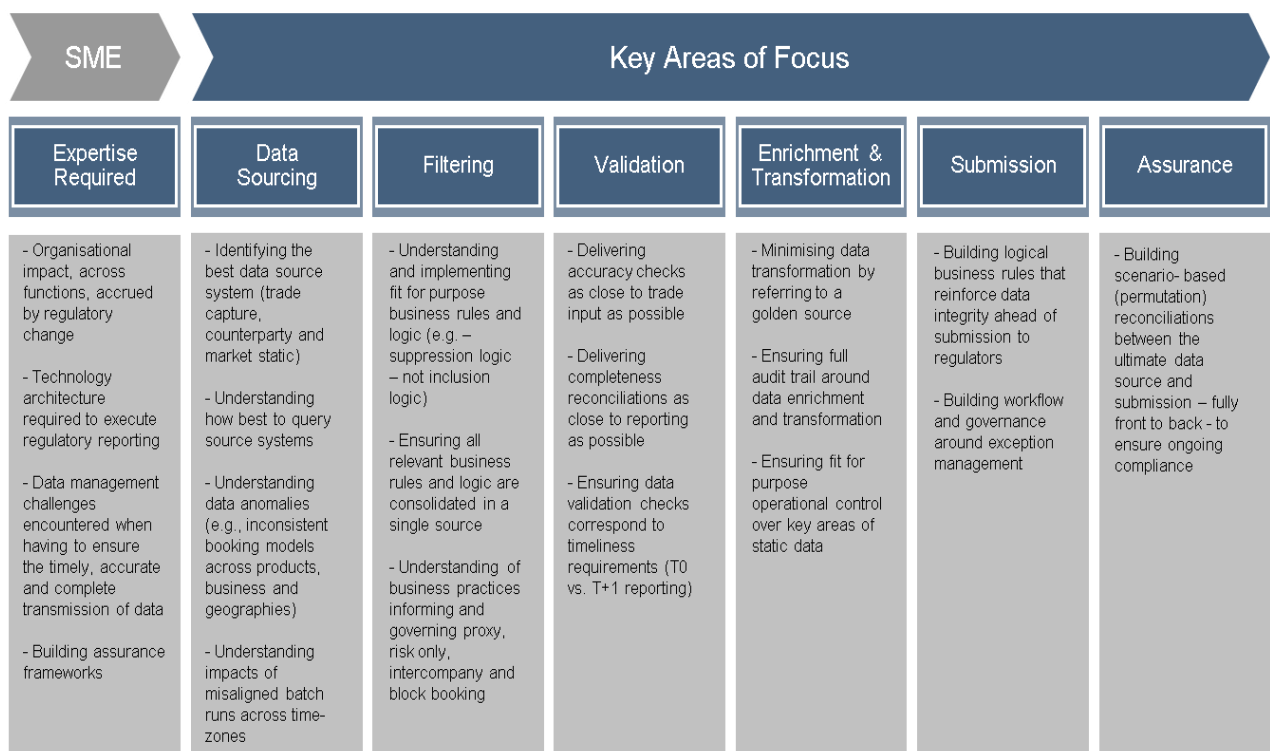


Figure 1: Assurance framework for Transaction Reporting data quality and integrity.

Enhancing Reference Data in Trayport Systems

Trayport is taking steps to help brokers ensure that the reference data stored within their Trayport systems is of a high quality. Initially, Trayport will be concentrating on product definitions, providing extra fields to ensure that there can be no ambiguity in definitions stored within the trading system. Furthermore, Trayport will be enhancing its Gold Mapping service to help brokers manage this data to ensure that it is error free. A central contract database, managed by Trayport, will detail such

information as lot sizes, trading calendars and clearing venue information for each product. Trayport will take care of ensuring this is updated and kept synchronized at each broker.

Compliance Operating Model

With REMIT on its way, Sapient Global Markets believe now is a good time for brokers to conduct a review of their compliance frameworks. Brokers that are able to demonstrate a robust operating and assurance model framework which covers governance, people, process, and systems will be able to navigate their reporting and monitoring obligations more swiftly in the upcoming intermediary state where the regulatory impact of REMIT is being assessed.

Governance

Any energy broker that is required to be REMIT compliant should have a governance group to spearhead its compliance efforts. The governance structure should define:

- Who at the brokerage is responsible for transactional reporting, monitoring market abuse, monitoring instances of market manipulation, and monitoring trading based on insider information
- The roles and responsibilities of all stakeholders across senior management, compliance, business, and technology
- How to, and who should, work directly with the regulators (ACER) and reporting service providers (if any)
- Budget allocation for current initiatives (BAU) and future change programmes

The existing MiFID requirements are based on a number of these points, and so in the main energy brokers are already doing most of these things. However, energy brokers will need to assess whether the existing processes that they have in place need to be modified to ensure compliance with REMIT.

People

Staff awareness of the changing regulatory and industry landscape is of paramount importance to ensure that energy brokers operate efficiently during this intermediate state.

The importance of REMIT and the implications of non-compliance should be firmly rooted into the culture of the brokerage. An awareness program should be devised, which should focus on:

- Mandatory compliance training requirements, such as CBT training for all staff
- Attendance of industry forums, monitoring regulatory newsletters, and transforming this industry knowledge into system and process changes (regulatory requirements driving business change and process)
- Internal communications of compliance matters

Processes

The broker should review their change management processes. The introduction and implementation of REMIT has the potential to bring with it a significant state of change for energy brokers and producers of wholesale energy goods. This change will have to be appropriately managed, benchmarking what has been observed in the investment banking sector. In a recent case under the MiFID post trade transparency reporting obligations, an investment bank was fined by the

FSA because it had not reported a large volume of transactions. After investigating, it was clear that this was caused by a product initiative that had been delivered to the market but not connected into the transactional reporting mechanism. To avoid this type of issue, brokers should ensure that they implement robust change management programme to ensure any changes made to processes or systems does not impact the ability of the firm to comply with REMIT requirements.

Systems

The broker will need to look at how operations and technology currently interact, and how this will change with the implementation of the regulatory reforms. Internal and external (service providers) systems will both be subject to scrutiny and assessed for compliance.

- **Data mapping/normalisation across systems:** Often there can be multiple source systems feeding transaction data in to a single reporting mechanism (referred to as a transaction reporting manager). The transaction reporting manager needs to sort the trade data into a standardised format which passes all validation checks for a transaction report to be sent. Problems can arise when the source systems have like-for-like fields which are named differently. These fields are often named differently than those required by the transaction manager when sending a transaction report. To ensure accurate transaction reporting, all the fields in each source system that could be affected will need to be identified and the like-for-like fields will need to be mapped to the fields required for transaction reporting in the transaction manager.
- **Mandatory reportable fields may not be readily available in the system.** They may have to be calculated separately, or they may need to be enriched from a different system, as is often the case with counterparty and instrument static data.
- **Not all trades will be reportable.** Therefore, a set of business rules will need to be developed to identify non-reportable transactions. It may not be straightforward to identify these types of trades in the current state.
- **Netting/aggregation of trades.** Same products might be traded on different systems or internal trades have taken place, which might place added complications for monitoring of market abuse/manipulation.
- **Product hierarchy/classification could be different from system to system,** making it difficult to aggregate or map to defined product classifications by regulators. This will also be a problem for energy brokers due to the different product classifications across various wholesale energy product producing firms.
- **Data should be stored in a way that allows for quick and easy access upon request by the regulator.**
- **Data retention** will likely be mandated when transactions are executed on behalf of the firm and on behalf of a client of the firm. Minimum data retention requirements could be extended significantly from the current state and SLAs will need to be reviewed for data storage and retrieval. Under the current MiFID requirements, it is mandated that transactional data needs to be held for a minimum of five years.

Summary

The introduction of REMIT brings a number of challenges not only for energy brokers and producers of wholesale energy products, but also for ACER and the European Parliament.

Further clarification is required from the European Parliament on several issues. REMIT does not appear to be clear in what its full reporting requirements will be, whether it extends to unfulfilled order books, or whether it differentiates between electronic and voice orders. There is still some ambiguity in the market. It remains to be seen which of today's three possible transaction reporting mechanisms the regulators will adopt. And, in terms of the market surveillance requirement, ACER still needs to explain which responsibilities will rest with the brokers, and which will be taken on by ACER itself.

In the meantime, brokers can prepare for REMIT's adoption by addressing the key points raised in this paper:

- 1) Reviewing their compliance operating model with respect to governance, processes, people, and systems
- 2) Reviewing their data assurance framework
- 3) Considering implementing a market surveillance system

Over the next 12 months, Trayport will introduce a number of new features to help brokers and traders meet the requirements of the new market structure, shaped by regulatory changes. We recognise that one size doesn't fit all and we are working with a broad spectrum of our clients participating in the European trading community to offer flexible solutions.

Trayport looks forward to continuing to help brokers to comply as the legislation develops.

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