Review of the Markets in Financial Instruments Directive

Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP

Response by ECT-Group

The Energy Commodity Traders Group ("ECT-Group") is a group of mostly German energy trading firms which established a joint working and discussion group for the exchange of experiences in financial and physical energy trading and for the co-ordination of the communication with German and European authorities. The ECT-Group consists of entities active in the energy trading sector; several of them pursue also banking activities or render financial services related to energy derivative products. Entities which pursue banking activities or render financial services related to commodity derivatives are according to the German Banking Act investment firms which have to apply for a license in order to carry out the banking activities or financial services related to commodity derivatives and which are supervised by the German Financial Supervisory Authority Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). The ECT-Group serves as a platform for such firms in order to develop common positions with respect to the financial supervision and to communicate them to BaFin and other legislative and administrative bodies. There has been a steady and successful cooperation between BaFin and the ECT-Group in order to develop an adequate supervisory regime for investment firms rendering financial services related to energy derivative products.

Theme	Question	Answers
Scope	1) Are the exemptions proposed in Directive Articles 2 and 3 appropriate? Are there ways in which more could be done to exempt corporate end users?	The ECT-Group, which will exclusively deal with the question as to which extent energy traders as typical commodity traders will be affected by MiFID/MiFIR, believes that the exemptions specified in Articles 2 and 3 MiFID are not sufficient. **1. No Cumulation of Exemptions** Initially, the general question is posed why it has not been decided that the exemptions could be used cumulatively. This question has been unclear for years. In one of its FAQ (European Commission > Internal Market > Practical info & problem solving > Questions on Single

		Market Legislation > Ref. 185.2) the Commission had actually already indicated that it assumes that the exemptions can be combined. This would also make sense since it is neither relevant for the protection of the market nor the protection of investors if a company, for example, deals on own account (without executing client orders) on the one hand and provides intra-group financial services on the other hand. The draft MiFID II, however, does not provide for this, which can be inferred from the fact that the wording of the exemption in Article 2 (1) lit. (i) is as such that it explicitly combines dealing on own account, group privilege and trading in commodity derivatives. We therefore recommend deleting the word “exclusively” from the exemptions, deleting the last paragraph concerning the exemption in Article 2 (1) lit. (d) and include a new lit. (o) at the end of Article 2 (1): „Persons who exclusively provide investment services in such a way that all investment services come under one of the above mentioned exemptions (a) to (n)”. **2. Insufficient Exemption for Ancillary Activity** Exemption (i) is especially relevant for the member companies of the ECT-Group, which are either energy utilities, energy traders or large-scale energy consumers (and are active as commodity traders in these functions). This exemption is, however, not sufficient for their typical business activities. This concerns primarily two issues. Namely the treatment of dealing on own account by executing client orders and the determination of the ancillary activity: **a) No execution of client orders ancillary activity** The **first paragraph** of exemption (i) reflects the exemption for dealing on own account. That means that all dealings on own account by the company in relation to all types of financial instruments come

		under the exemption. Only transactions concerning the execution of client orders are excluded therefrom. Initially, this is comprehensible: thus, an industrial company may acquire, for example, cross-currency derivatives or interest rate derivatives for own hedging purposes. Why an energy utility should, for example, support another company in relation to interest rate derivatives would not make much sense. The **second paragraph** introduces the group privilege, according to which also other investment services may be provided as long as they are exclusively provided for companies of the affiliated group. Any dealings on own account are, however, exempted therefrom because they were already referred to in the first paragraph. But this also means that dealing on own account may not even be executed within an affiliated group if such transaction is based upon an order by, e.g. its own parent undertaking. The same picture is given in the **third paragraph**. Here the company – as is already provided for in currently applicable version of the exemption – is given the opportunity to provide to their own clients investment services in commodity derivatives as an ancillary activity. However, also here dealing on own account is excluded. This means that for an energy utility wishing to procure for its customers also financial instruments in energy trading, it is no longer possible to fulfil this by executing client orders. Instead it would have to arrange for or provide advice on these transactions. From the client's perspective it is, however, the same if the transaction is executed by way of two purchase and sales contracts, or if a sales contract with a third trading party is arranged for. In terms of the client's risk management it would be even easier if his primary contact would also be his supplier. Contrary to the still applicable legal situation, this circumstance will be of dramatic significance. Because of the **changed definition of financial instruments**, many more commodity products will be defined as financial instruments. This is based upon the fact that all

		forward or future products that are not only traded on exchanges or MTFs, but in the future also on **OTFs** must automatically be defined as financial instruments. The client, however, is typically only interested in the physical delivery of energy. He does not care whether the electricity for the coming year has been purchased bilaterally or via a broker platform, as long as he is supplied with electricity in the following year. In other words: from the perspective of the market, no difference is made between physical transactions that are traded OTC or on a regulated market/MTF/OTF. There is one more thing: On the basis of **EMIR and Title V of MiFIR** it shall be taken care that these transactions "leave" the traditional OTC sector and "enter" the world of exchanges, MTFs and OTFs in the middle term. In this case, nearly all energy wholesale products would, even if they were to be fulfilled physically and their only purpose was to be delivered, mutate into financial instruments (or be only available from the large market participants in this form). Exemption (i) does not provide an adequate answer to this. A **simple solution** would be to delete the limitation "other than dealing on own account" from paragraphs 2 and 3 of exemption (i). As a result, we would still have a complex system where a company could deal on own account in all financial instruments serving its own purposes, provide for its affiliated group also investment services in all financial instruments and, finally, continue to provide for its clients as an ancillary service all investment services in commodity-specific financial instruments, including dealing on own account to execute client orders. **Another solution** is indicated in the recitals: according to these, transactions concluded between two undertakings that would each be covered by the exemption in relation to an ancillary activity, shall never be deemed as dealing on own account to execute client orders. This would be the (slightly worse) solution, which, however, has not

		yet been incorporated in the text of the regulation. **b) Definition of Ancillary Activity** The second problem emerging lies in the definition of ancillary activity. The ECT-Group welcomes the fact that a central solution shall be found for the vague definition of ancillary activity. The basic approach to consider commercial purposes in this respect is also welcomed. But this is likely to be dangerous ground, because these criteria do not offer any definite requirements. The definition of ancillary service, though, will be of decisive significance since – as mentioned above – the scope of financial instruments in energy trading will be expanded dramatically. If it should happen that nearly all energy wholesale products will nominally become financial instruments, it could result in energy utilities, which today primarily carry out physical transactions, buying and selling more "financial products" (i.e. derivatives according to the MiFID) than physical products. Hence, a final decision on the impact of MiFID may only be made once the companies will have developed a feeling for what is meant by an objectively measured activity to the main business as proposed by the Commission. When transposing the first MiFID into German law, the German legislator has made clear in its reasoning that in the case of energy utilities it is always assumed that the supply of the population with energy, the generation of energy and the transport of energy are considered the main business. A similar determination by the Commission would be extremely desirable to ensure legal certainty.
	2) Is it appropriate to include emission allowances and structured deposits and have they been included in an appropriate way?	In the view of the ECT-Group it is not appropriate to include emission allowances in MiFID in the manner proposed. It is questionable whether emission allowances can be at all compared

		with classic securities. It is comprehensible that in this context the focus is put in particular on more market transparency and on preventing market abuse. However, this decision has such serious consequences that it appears to be inappropriate as a whole. The statement made in the reasoning to MiFID that only a few of the traders operating in the market will be additionally supervised, is not totally correct. This thought is based on the assumption that only the traders that have been trading in CO2 emission allowances only on the spot market will be the new ones under supervision. According to this assumption, the majority has already been under supervision as the majority offers forward products in relation to CO2 emission. It is correct that many CO2 traders offer forward products. It is incorrect, though, that they have been under supervision for this, because CO2 emission allowances sold forward, which were then really delivered and at the same time were not traded over a regulated market/MTF, have not been derivatives within the meaning of MiFID and thus under no supervision. This means that, except for the banks, almost all traders that have been trading in CO2 emission allowances, whether on the spot or on the futures market, have not been under supervision. For this reason, the new scope of application is much wider than the Commission expects it to be. Furthermore, there are additional companies that are definitely outside the focus of a financial supervision. These include companies that offer to their customers an electricity supply concept based on a so-called power plant capacity share. In this context, a customer is given the possibility to use a share in the generation capacity of a power plant. So, the power generation capacity of a physical power plant is virtually attributed to individual companies which could call on their share in the capacity generation. This means that they actually lease a part of the power plant. In terms of economy and energy efficiency there are only benefits: several energy consumers or utilities can share

		the costs for one bigger power plant, the construction of which is as a result more cost and energy efficient than a number of smaller power plants. Usually it is the task of the „leaseholder“ to give the technical power plant manager (which as a rule is the “lessor”) the CO2 emission allowances, who has to surrender them for the operation of the power plant. It has been absolutely unproblematic so far if the power plant manager purchased the emission allowances on the market and then sold them further to the customers to have them returned at the time of the delivery obligation. According to this model, the same power plant operator would “mutate” into a CO2 trader under financial supervision. This is surely not what is intended. The only way to escape it would be by making use of the exemptions mentioned under question 1 above. Finally, the intended change would indirectly affect numerous power plant operators that are subject to the emission trading scheme all across Europe. Alone in Germany more than 2000 companies that are enforced (!) to deal with emission allowances would be affected. They will find fewer trading partners, will have to account for higher transaction costs and deal with the fact of having to handle financial instruments, which will lead to organisational adjustments and restructurings in the companies the business of which is firmly anchored in the “real economy”.
Corporate governance	5) What changes, if any, are needed to the new requirements on corporate governance for investment firms and trading venues in Directive Articles 9 and 48 and for data service providers in Directive Article 65 to ensure that they are proportionate and effective, and why?	Based on the direction taken by the MiFID/MiFIR it is to be expected that more specialist energy traders will be under financial supervision in the future. An important issue in the application of a relevant permit is the qualification of the managerial personnel. Too schematic applications from the world of banking/financial service providers would be inappropriate in this context. The managing staff of such a specialist energy trader has as a rule an extensive experience in energy trading – probably also in trading over the exchange. However, people that beyond that have an

		apprenticeship in banking or relevant studies are rarely found. Article 9 (1) lit b should be understood in such way that adequacy of knowledge shall be explicitly referred to the activity of the specific investment firm. For the energy trade this means that experience in managing must be sufficient for energy trading that is not subject to supervision, for example if not being subject to supervision was ensured by exemptions. This comes into question only for trading for hedging purposes, OTC futures trading with merely physical products or the trading as ancillary activity for customers of the main activity. For in the supervised financial energy trading barely anyone has ever been able or forced to make experience in this area.
Organisation of markets and trading	6) Is the Organised Trading Facility category appropriately defined and differentiated from other trading venues and from systematic internalisers in the proposal? If not, what changes are needed and why?	While the meaning of the category OTF in relation to the definition of financial instrument has already been explained above, the term itself is still not completely clear. The main distinction between an MTF and an OTF appears to exist solely in the binding character of the rules applied by facility operators to bring together parties to a contract. What becomes clear is the political will to have all options of broker platforms under supervision. This means that only the individual bilateral trade over phone, via email or facsimile would not be regulated. It is not clear, for instance, whether individual brokers would be considered as OTF. This appears possible, based on the wording, but would be too wide. Thus they should be explicitly carved out.
	7) How should OTC trading be defined? Will the proposals, including the new OTF category, lead to the channelling of trades which are currently OTC onto organised venues and, if so, which type of venue?	**1. OTC Definition is Ambiguous** Expanding the scope of the definition of trading venues to such an extreme extent that all venues that are considered a regulated market, MTF or OTF are included, leaves hardly any room for anything else. It would be appropriate to define OTC trading only in a way which

		distinguishes it from other trading venues. Currently there is a broader understanding according to which OTC is considered everything that is not traded on "regulated trading venues", whereas MiFIR's aim is to provide a very narrow definition of OTC transactions. In the future, OTC trading would probably be only trades that were not traded on a venue pursuant to Article 2 (25) MiFIR. **2. Shifting of Trading** The ECT-Group believes that many small traders would withdraw from the sector, which would then still carry the name OTC, if the proposals currently made would not be changed. This has less to do with the fact that traders would choose to move on to other market places, but rather with the fact that the market places used by traders to date (broker platform etc.) would, in any case, come under the supervision of MiFID. Especially in the energy trading sector many traders have avoided deliberately exchanges and large trading venues (MTFs) to stay away completely from the financial services sector with their physical energy transactions, where energy is really delivered. In this way, they did not depend on whether they would provide financial services and whether they could use the exemption given in Article 2 (i) in this respect. Thus, they could avoid a certain uncertainty of interpretation by the national authorities. In the future, this way would be blocked, unless they limited their trading activities exclusively to bilateral trading via phone, fax or email. Today, these "remaining options" make it nearly impossible to carry out efficient energy trading. In combination with EMIR, traders would be forced to carry out clearing activities as well if the larger market participants coming directly under EMIR would succeed in establishing this as a requirement. Under these circumstances, even more transactions would be gathered at the exchanges, which right now offer the

		appropriate clearing infrastructure. In the energy sector, this would mean that large parts of the energy wholesale are likely to go to EEX/ECC. The members of the ECT-Group believe that this is certainly not only an advantage for the systemic risk. The competitive pressure imposed, to date, on the regulated markets by electronic platforms (keyword: transaction costs) would also be unnecessarily reduced.
	11) What is your view of the requirement in Title V of the Regulation for specified derivatives to be traded on organised venues and are there any adjustments needed to make the requirement practical to apply?	As already mentioned above, Title V of MiFIR will have a serious impact on energy trading. Since neither electricity nor gas is generated or produced at the moment they are used by the consumer, nearly all transactions are traded forward in time. The primary task of the spot market is to correct long-term transactions at short notice. For example, this becomes necessary if on the basis of a long-term forecast energy is bought on the forward market, but this forecast is adjusted day by day on the basis of short-term circumstances. As shown above, most energy companies use the physical wholesale market, which, by definition, is not subject to financial oversight. But since the physical products are immediately identified as financial instruments as soon as they are traded on an exchange or MTF, the expansion on the basis of the OTF definition is already of great significance. If now the provisions of Title V provide for the opportunity that ESMA will declare all standardised energy products as products that must be traded (and cleared) on trading venues, then there will be potentially no longer an OTC market for standardised products. Since the large traders (depending on the EMIR threshold still to be defined) would then be forced to trade these products among each other and with the banks only as cleared products on trading venues, they would have little incentive to trade with the smaller market participants do without clearing and the convenience of the trading venues. Every trading party that does not have to fulfil the same

		clearing obligations, would pose a liquidity risk to the large trader/bank. The original idea behind the entire regulation was to have a better control of dangerous financial market derivatives such as CDS etc. It might therefore be helpful to define that certain commodity derivates shall not at all be affected. The actual parties benefitting from such regulations would be exclusively the exchanges and clearing providers. Customers would be very likely to have to face higher prices since the whole market would be more illiquid and burdened with higher transaction costs.
	14) What is your view of the powers to impose position limits, alternative arrangements with equivalent effect or manage positions in relation to commodity derivatives or the underlying commodity? Are there any changes which could make the requirements easier to apply or less onerous in practice? Are there alternative approaches to protecting producers and consumers which could be considered as well or instead?	The ECT-Group firmly believes that the powers given to the national authorities and ESMA, as specified in Articles 31, 31 draft MiFIR, to impose bans or restrictions on the marketing, distribution and sale of specified financial instruments (hereinafter: position limits) in energy commodities (electricity, natural gas, hard coal and emission allowances) are objectively not justified, incompatible with fundamental legal principles of the European Union and detrimental to market participants from the commerce sector. The ECT-Group, therefore urgently suggests that market participants from the commerce sector be excluded from the empowerment pursuant to Articles 31, 32 MiFIR. In detail: **1. No objective justification** For the use of energy derivatives by the commerce sector it is objectively not required to impose position limits as defined in Articles 31, 32 MiFIR. In recital (24) of MiFIR the powers to impose position limits are justified on the grounds of investor protection, the orderly functioning and integrity of financial markets, and the stability of (part of) the

		financial system. None of these reasons is relevant for the use of energy derivatives by enterprises from the commerce sector: If commercial enterprises buy or sell energy derivatives this happens exclusively in relation to other professional market participants. End-consumers/ private persons being in the focus of investor protection are not at all affected. Neither the Enron Collapse in 2001 nor the financial crisis since 2008 were triggered in any way through the use of energy derivatives by commercial companies. That is, the use of financial instruments by these companies did not in the least create a systemic risk, thus affecting the stability of financial markets. Such an adverse effect is not going to be expected in the future, either, since these market participants use energy derivatives almost exclusively to hedge their industrial transactions but not to speculate on financial markets. Finally, the authorities of the European Union and the Member States have no clear evidence that the companies from the commerce sector had shown abusive behaviour in relation to the use of energy derivatives. All in all, the proposed powers to impose position limits in relation to energy derivatives used by the commercial sector are lacking any objective justification. **2. No Compatibility with Fundamental Legal Principles of the EU** The lack of an objective justification is a serious indication for the unlawfulness of the proposed regulation: The imprecise and undifferentiated provision governing the prerequisites of a prohibition in Articles 31, 32 MiFIR violates the rule-of-law principle applicable in EU law. The provisions mentioned are too vague and violate the so called prohibition of disproportionate

		measures. The prerequisites of a prohibition specified in Article 31 II and Article 32 II MiFIR are merely a collection of undefined terms from the finance sector that have nowhere been defined in detail. Thus, it remains absolutely unclear under which actual circumstances ESMA or the national regulators permit interference with the market participants' freedom of commercial activity protected by the Basic Law, as stipulated in Articles 31, 32 MiFIR. Another drawback is that no differentiation is made between financial institutions and commercial companies. Besides, the proposed prohibitions are – as shown above under 1. – unfit to achieve the intended objectives. The explanations under 1. have also shown that an undifferentiated definition of the prohibitions, i.e. extending their scope also to companies from the commerce sector that use energy derivatives for hedging purposes, is absolutely disproportionate, because of placing too much of a burden on companies. **3. Unreasonable Economic Burden place on Commerce Sector** The proposed prohibitions also place an unreasonable economic burden on commercial companies. These use energy derivates primarily – as mentioned above – to hedge risks associated with the price and procurement of the commodities required for their actual production. That is, these companies become active in the energy derivatives market, their activities not being "an end in itself", i.e. for speculative reasons, but to support/facilitate their main business. This applies even more so for energy utilities, which use energy derivatives to fulfil their production and delivery obligations towards their customers. Thus, the undifferentiated definition of the powers to impose position limits poses the obvious risk that such limits will not benefit the financial markets (as the recent experience of CFTC with

		position limits has shown), but rather place a unnecessary burden on the "real economy".
	28) What are the key interactions with other EU financial services legislation that need to be considered in developing MiFID/MiFIR 2?	In view of the effects that MiFID and MiFIR will have, above all EMIR and CRD need to be considered. **1. EMIR** The interaction with EMIR has already been indicated above. EMIR, MiFID and MiFIR will interact with each other in such way that a big part of the physical energy trading is transformed into financial instruments. The liquidity requirements arising from the enforced clearing according to EMIR will also lead to problems in the market. After all not all market participants are meant to be affected, as this shall only be limited to the financial institutions and large-scale traders. Still, for reasons of cost efficiency (standardisation of transactions, costs of initial and variation margins) they will continuously seek to agree on clearing with all trading partners, as depending on the market development especially the variation margins might reach relatively high values. For a trader without physical business, like banks, this won't be problematic: the amount that such trader has to pay as variation margin on the one hand, will be credited to him on the other. Whereas due to the market situation, an energy supplier at the end of the chain cannot agree on margin payments with his customers. End users of electricity and gas will certainly not pay in advance for electricity or gas that they are maybe going to consume two years later. **2. CRD** The second most important question is CRD. If it happens that more energy traders are to become financial service providers so that they are under financial supervision, a decisive aspect will be the equity

		capital they hold. Furthermore, they are often subject to concentration risks as the majority of their business transactions are as a rule made with affiliated companies. The usual constellation is that an energy company founds a specialised subsidiary that offers financial services on the market and secures them by means of back-to-back transactions with the parent company. Or if a specialist trading company has to offer the production of an energy company on the futures market, the energy would be purchased from the power plant company or the parent company and then put for sale on the market. The same would apply if the respective function between the wholesale market and the sales to the end consumer is assumed. Presently there are two exemptions for commodity dealers in relation to equity capital. Both are being under review and have a limited duration until 31 December 2014. It must be clear that an expansion of the financial services will lead to more companies being subject to capital requirements. This is at least possible as far as the current exemptions are going to exist in this or in a comparable form. If these exemptions cease to exist at the end of 2014 in parallel to the implementation of MiFID, not only the few energy companies that already have a permit under MiFID but all companies that would be obliged to have them would most likely spare the effort. First calculations have shown that no acceptable return on equity could be generated from the energy trading business. Instead, large amounts of the energy companies' equity would be bound, which is now more necessary than ever to afford the restructuring of the energy industry to renewable energies, just the way Europe will require it to be in the next few decades .