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Mr. Philip LOWE
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11 July 2011

RE: MiFID review

Dear Mr Lowe,

As you will be aware, the European Commission (EC) is due to bring forward a legislative proposal for revising MiFID in October, following an initial consultation at the beginning of 2011. In anticipation of the internal EC process for developing the legislative proposal, the European Federation of Energy Traders (EFET)[1] **would much appreciate the opportunity for a small, expert delegation to come and speak to you and your colleagues responsible for liaison on MiFID in DG Energy. During a meeting (which we trust could be arranged early in September) we could outline our concerns in more detail and provide specific legislative text for possible MiFID amendments.**

Many EFET member companies are anxious about the parts of the EC proposal dealing with commodity derivatives, including energy futures. We believe indicative changes will have a major negative impact on the functioning of wholesale energy markets and on competition in the internal markets for power and gas. In particular the liquidity and depth of EU wholesale electricity and gas markets will be compromised. This will jeopardise the EC's objective of completing the single EU energy market by 2014.

EFET is supportive of the overall intention behind the EC review of MiFID, to ensure it underpins the further development of transparent and efficient financial markets and strengthening of investor protection across the EU. We believe that many elements of reforms proposed by the EC in the consultation earlier this year will help to achieve this

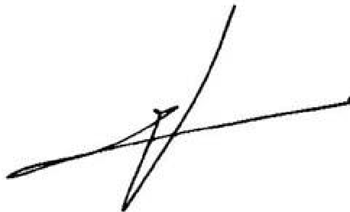
[1] The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. EFET currently represents more than 100 energy trading companies, active in over 27 European countries. For more information, please refer to: www.efet.org.

objective. However, a number of our concerns have not been alleviated in our discussions so far with DG Market. We set out in the annex to this letter a short explanation of these concerns. We shall be happy to provide any necessary clarification during our meeting with you. We trust you and your colleagues in DG Energy will keep EFET concerns in mind in the coming weeks, as the EC prepares its legislative proposal for revising MiFID.

We look forward to hearing from you soon. In the meantime, if you have any questions about the content of this letter please contact Peter Styles (Member of the EFET Board, Chairman of the EFET Electricity Committee), Karl-Peter Horstmann (RWE) or Cemil Altin (EDF Trading)[2] who are Chair and Vice-Chair respectively of the EFET Task Force Market Supervision, which is responsible for handling the MiFID review and related financial and wholesale regulatory reforms.

Yours sincerely,

On behalf of the European Federation of Energy Traders (EFET)



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EFET European Federation of Energy Traders

Annex 1

EFET key concerns with the MiFID review

1. Revision of the current MiFID exemptions applicable to some types of energy market participant

The EC proposed in its consultation paper a potentially significant tightening of the current exemption framework within MiFID[3] which we believe would unnecessarily capture firms that should legitimately remain outside of the MiFID framework.

We believe that the EC has not provided any compelling rational or evidence for such significant changes to the regulatory framework. It is crucial that there is a full understanding of the potential impact and consequences for the energy commodity sector and its participant firms of any changes to the existing exemption framework. For example, market making in energy markets has played a key role in providing liquidity and allowing wholesale energy markets to develop effectively so all players have the ability to access markets to manage their risks. Energy firms would not be able to support wholesale markets in this way if a consequence of doing so meant being brought into framework of MiFID. We believe that if the specifics of the sector are not taken into account, and the scope of MiFID is extended too far, **there is a real risk that the EC's liberalisation objectives for the energy sector would be undermined** as there would be:

- a contraction in the overall size of the energy market and increase in concentration while those firms that do remain active risk becoming price takers from financial institutions. This would increase the level of systemic risk associated with financial firms;
- a significant reduction in liquidity, which would push up trading costs, bid-offer spreads and price volatility;
- an increase in the overall level of risk in the energy sector as firms reduce their hedging activities because of the increased costs; and
- a weakening of the price discovery process as firms resort to hedging their risks outside of the wholesale traded market.

Those firms that are brought within the scope of MiFID could need to hold significant, and potentially damaging levels of capital to cover their exposures under the current Capital Reserve Directive (with potentially additional obligations based on changes arising from the forthcoming review). They would also be subject to mandatory central clearing of all of their OTC derivative transactions under the EC's proposed EMIR legislation which would impose a significant cash liquidity risk which many firms will find impossible to manage at a reasonable cost.

[3] In particular the proposal in the MiFID consultation paper to delete the existing exemption for commodity trading firms (exemption 2.1(k)); the significant tightening of the exemption for ancillary services (exemption 2.1 (i)); and the danger that crucial liquidity services provided by energy firms to ensure wholesale energy markets operate efficiently and effectively would result in these firms being brought within the scope of MiFID (exemption 2.1(d)).

The capital costs and the margining costs that may arise from such obligations would potentially be prohibitive to some firms, which would mean they will have to significantly scale back their current activities (such as hedging commercial risk and optimising assets such as power stations or gas production facilities), in some cases restructuring their trading entities to create small fixed asset-light firms or be forced to exit the wholesale traded market or seek to hedge their risks through long term bilateral contracts.

An alternative approach is therefore necessary to avoid these unintended consequences while meeting the concerns of the EC to ensure the exemptions framework is sufficiently robust and applied consistently across the EU. EFET would welcome an opportunity to share its specific alternative drafting on the exemptions.

2. The definition of a financial instrument

The EC proposed in its consultation to change the definition of a financial instrument in a way that would capture almost all physical energy transactions (i.e. anything that was not a spot market transaction). This would have a number of negative consequences:

- It would represent a radical redrawing of the boundary between energy and financial sector regulation which would not be appropriate given the physical underlying nature of the sector. This would dramatically reduce the scope of the recently agreed REMIT and potentially risk severe dislocations in the effectiveness of regulatory oversight as financial regulators take time to develop their understanding of the physical energy markets;
- It significantly increasing the probability that a non-financial firm could breach the clearing thresholds envisaged under the EC's EMIR legislation as significantly more transactions would be classified as derivatives; and
- It would be inconsistent with US proposals in the Dodd-Frank Act and the implementing rules proposed by the CFTC.

EFET believes there is therefore no justification for changing the existing definition of a financial instrument within MiFID.

3. The requirement that all standardised financial instruments must be traded through exchanges, MTFs or organised trading venues

We do not support the EC's proposals to require that all derivatives eligible for clearing and that are sufficiently liquid should be traded exclusively on regulated markets, MTFs or organised trading facilities as it would:

- push the majority of OTC derivative transactions in the energy sector to cleared platforms undermining the EC's proposals for clearing thresholds for non-financial firms under EMIR;
- reduce the ability of firms to negotiate contracts to meet their specific hedging requirements; and
- stifle future innovation and undermine competition between trading venues as envisaged by MiFID.

EFET European Federation of Energy Traders

4. The classification of emission allowances (in the context of secondary spot trading) as financial instruments

This proposal is not appropriate. This is because EUAs do not:

- confer financial claims against the public issuer of such allowances;
- represent titles to capital (with voting rights) or title to debentures; or
- constitute forward contracts.

Emission allowances are designed to serve climate change objectives and their primary purpose is not to serve as an investment product. The Prada Commission (in France) called for the application of a regime similar to MAD and MiFID to emission allowances, but it expressly excluded any re-qualification of emission allowances as financial instruments. Furthermore, if EUAs are classified as financial instruments, some legal obligations would become too burdensome to comply with especially for industrial SMEs as well as some small power utilities. There would therefore need to be a complex (and difficult to monitor) exemptions framework within MiFID.

EFET however recognises the concerns regarding market integrity and transparency in EUA markets, and we intend to propose to the EC the general outline of a sector specific legislative mechanism, along the lines of REMIT, which would deliver a robust regulatory regime that avoids the need for reclassifying these products as financial instruments.