EFET Response to
Review of the Markets in Financial Instruments Directive
Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP

The European Federation of Energy Traders (EFET)\(^1\) appreciates the opportunity to respond to this questionnaire on the MiFID review. We have limited ourselves to commenting on those issues that are directly relevant to energy markets.

We support the objectives of the MiFID review, namely the strengthening of investor protection and the improvement of transparency and efficiency in financial markets. Our main concerns relate to the revised exemptions regime proposed by the Commission (see our answer to question 1), and the definition of financial instruments (see our answer to question 7). We also comment on the effect of mandatory platform trading, position limits, and other important aspects of the proposals.

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?

Most energy companies are currently exempt from MiFID on the basis of provisions for specialist commodity traders.\(^2\) If they were to lose this exemption, they would be forced to use central clearing for all their derivatives trades under the European Market Infrastructure Regulation (EMIR). They might also have to comply with capital requirements designed for financial institutions under the Capital Requirements Directive (CRD). These requirements would increase the costs of trading in the sector, which would, in turn, discourage hedging, reduce liquidity, and divert capital away from physical investments.

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\(^1\) 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.

\(^2\) See Article 2(1)(k) of MiFID I, proposed to be deleted.
The Commission has recognised these risks and is proposing to retain an exemption for non-financial counterparties in its proposals. More specifically, MiFID II shall not apply to companies whose trading activity is ancillary to their main business.

While this clause provides a useful basis for discussion, EFET is concerned that it might still lend itself to restrictive or inconsistent interpretations. As such, EFET believes that it is necessary to clarify the purpose of the exemption and translate the resulting concept in clear legal language. The presumption should be that energy firms can remain fully exempt from MiFID II provided that they trade primarily to manage their commercial positions and hedge their exposures to price risks.

The proposed wording of the exemption 2(1)(d) which excludes persons “that are a member of, or a participant, in a regulated market or MTF” makes the exemption very narrow. In general, almost all market participants are participants of regulated markets or MTF. If the purpose is to make sure that this exemption does not benefit algorithmic traders, then this should be clearly stated (see section on specific comments).

The issue of the exemption regime is closely related to the definition of financial instruments. We return to this issue in our answer to question 7.

2) Is it appropriate to include emission allowances and structured deposits and have they been included in an appropriate way?

EFET believes that the proposal to define Emission Allowances – i.e., EU Allowances (EUAs), Certified Emission Reductions (CERs) and Emission Reduction Units (ERUs), all units recognised for compliance in the EU ETS – as a separate class of financial instruments in MiFID II is not appropriate. Although Emission Allowances do share some common features with other classes of financial instruments, such as transferable securities (e.g. dematerialised bearer bonds held in a clearing system), they are distinguishable from such types of financial instrument for several reasons. They do not confer financial claims against the public issuer of such allowances; they do not represent titles to capital or title to debentures or constitute forward contracts. The operators of installations subject to the ETS system are effectively forced to trade Emission Allowances to ensure that they comply with emissions reductions and to avoid sanctions in case of non compliance. Emission Allowances primarily serve cost efficiency in climate protection and they are not investment products.

The Commission’s impact assessment acknowledges that it is not possible to estimate the impact of the classification of Emission Allowances as financial instruments for market participants; moreover, the assessment did not address the potential impact for the participation in and the liquidity of the carbon market. EFET believes that such a classification has the potential to trigger unintended consequences that may be damaging for the EU Emissions Trading System, at a critical moment for this policy instrument.

Finally, the classification of CERs and ERUs as financial instruments is likely to put the European carbon finance industry at a disadvantage as EU-based investors in the primary carbon credit market may be subject to requirements triggering significant transaction costs, thereby creating an uneven playing field with competitors located outside the EU.

4) Is it appropriate to regulate third country access to EU markets and, if so, what principles should be followed and what precedents should inform the approach and why?

We welcome the proposal that third country companies for which an equivalent decision has been adopted would be able to request to provide services in the EU. However, the assessment of whether the regulatory regime of a third country is equivalent should not be too strict, because it would be very difficult to have in place identical regimes in all respects. Therefore, we propose that equivalence should be defined in terms of principles regulated and general procedures rather than in terms of specific provisions.
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?

The theoretical distinction between OTFs and other types of trading venues seems clear. OTFs are granted discretionary powers in trade execution, as opposed to MTFs and regulated markets. However, the practical implications of this definition are unclear. EFET is concerned about the implications of the requirement to trade on organised platforms, including OTFs (see our answer to question 11). The impact assessment provided by the EU Commission fails to quantify these implications, and the potential impacts might be widely underestimated.

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?

OTC trading should continue to be defined as trading outside regulated markets, as currently defined in MiFID. Therefore off-exchange trading should still be considered OTC.

More importantly, the Commission’s proposals fail to clarify the distinction between financial instruments and physical contracts. Financial instruments are defined in MiFID Annex 1 and have the characteristics of being standardised, traded on an exchange or regulated market and subject to clearing or cash margining. We are concerned that the amendments to Annex 1, C (6) may improperly lead to a classification of a contract that is settled physically and traded on an organised trading facility (OTF) as a financial instrument. This could potentially encompass physical energy contracts, which would have damaging implications for the energy sector.

The gas and power markets trade financial instruments on exchanges, but the majority of transactions in the EU are classified as Physical trades and traded “over the counter” (OTC), mainly on broker screens which will be classified as Organised Trade Facilities (OTFs) or Multilateral Trade Facilities (MTFs) under MiFID II. These Physical trades are then either “Spot” (for delivery within day or day ahead) or “Forward” (for delivery at some point in the future). In both cases, the transactions are physically delivered, do not involve cash settlement and are not to be considered as derivative transactions.

Physically settled means that firms actually deliver the physical commodity involving scheduling of the physical delivery to the designated delivery point (e.g. gas hub or price area). They are, therefore, fundamentally different to cash settled instruments and do not as such pose any risk to the financial markets, from which they remain segregated. This crucial underlying physical nature of the products mean they should be regulated by energy regulators under the auspices of the dedicated sectoral regulation of REMIT and other existing legislative tools including security of supply standards, licensing, etc. There is no justification for treating physically traded commodity products as financial instruments; however, the consequences of doing so will have significant implications for MiFID and EMIR, the structure and liquidity of the market and the effective regulation of the market.

The possible consequences of Physical Forward transactions being considered financial instruments include:

– implications regarding the framework for non financial firms under EMIR, namely the consideration of transactions in physical forwards for the purposes of calculating the clearing threshold and the enforcement of position limits and position reporting;

– the scope of the ancillary activity exemption 2.1.i) would be substantially reduced as the commercial activity related to physical forward transactions, which is part of the main non-financial activity of energy firms, would be regarded wrongly as its main financial trading business (i.e. trading with financial instruments).

– If Commodity Firms lose their general exemptions from MiFID (and cannot make use of the Ancillary Services exemption 2.1.i), then all transactions in financial instruments would
need to be cleared under EMIR provisions (and potentially subject to further collateralisation under Capital Requirements Directive). This would increase transaction costs and require significant sums of money to be tied up in margining accounts rather than being used by the producers and generators for investment in projects. That situation is unlikely to be economic, with the consequence that physical players will reduce both volume and duration of trades, reducing market liquidity, contrary to Third Energy Package objectives.

- REMIT would only cover within day and day-ahead transactions (“spot”). The remaining transactions would be covered by MIFID/EMIR/MAR, creating overlaps and regulatory burden. Moving the boundaries of regulation for physical transactions to financial regulators will undermine the effective and well established framework of energy regulation. REMIT provides for an oversight framework and transaction reporting requirements, which means that any potential systemic risks posed by energy markets are monitored.

Incorporating appropriate and clear wording within the legislation is the simplest mechanism for maintaining a clear delineation between physical and financial instruments. To this aim we recall also article 38 of MiFID implementing Regulation EC n. 1287/2006 (Characteristics of other derivative financial instruments), where is given a clear definition of specific and cumulative conditions that must be met by certain instruments to be defined as derivative financial instruments.

It is important to note that the US Dodd-Frank Act explicitly excludes Physical Forward transactions from the legislation and we believe that maintaining this treatment in EU legislation is appropriate.

Our proposed approach is to insert a clause that explicitly states that physically settled transactions are not considered financial instrument.

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?

A large share of energy derivatives in the EU are currently traded OTC on broker platforms. These markets are still in their infancy, and they remain for the most part illiquid, bespoke, and non-continuous. These markets still require broker support to function efficiently: specialised brokers ‘work the market’ by monitoring interests from different parties and encouraging buyers and sellers to amend their orders to match market needs. Such services are an essential route to market for both established players and smaller new entrants who may not have the resources to scrutinise market developments continuously.

Importantly, these trading arrangements provide flexibility without impairing transparency: interests and transactions are posted to all market participants, not just a ‘club’ of major players, and serve to establish trusted market indexes. Moreover, the preservation of the OTC market is compatible with the growth of central clearing, which is another central objective of MiFID and EMIR: it is possible to execute a trade OTC and then hand over this trade to a clearing house for clearing and settlement (energy companies already use this type of hybrid arrangement at present). The important feature of the existing arrangements is that different types of platforms compete against each other to accommodate new developments, meet the needs of market participants, and support the development of evolving energy markets.

As such, EFET is concerned that the proposed measure in Title 5 may reduce the range of services and routes to market available to market participants. There is also a risk that this requirement may increase transaction costs by imposing new requirements on existing trading venues.

To be clear, we see a risk that these provisions might fragment the market if the majority of participants move their trades to regulated platforms. Such a development would reduce liquidity and make price discovery more difficult, which goes against the stated objectives of the measure.
Against this backdrop, EFET recommends the following:

– The OTF category should be maintained. Where derivatives trading has to be moved to regulated venues, then the range of venues that can host these trades should include voice brokers.

– The liquidity test should be strengthened. The Commission’s proposal specifies that ESMA should assess the liquidity of a class of derivatives by reference to the size and frequency of trades and the type and number of counterparties. EFET would recommend adding the bid/offer spread to this list of criteria as it is in the main indicator of liquidity used by energy market participants.

13) Are the provisions on non-discriminatory access to market infrastructure and to benchmarks in Title VI sufficient to provide for effective competition between providers? If not, what else is needed and why? Do the proposals fit appropriately with EMIR?

We welcome rules to ensure non-discriminatory access to market infrastructures. We believe that rules on conditions to access central counterparties and trading venues should be very clear and should not remain exclusively theoretical. In particular any refuse to provide access should be duly motivated.

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?

EFET does not support the empowerment of regulated platforms (e.g. exchanges) and regulators to establish ex-ante position limits in respect of commodity derivatives.

Position limits hinder effective risk management as companies would be allowed to manage their commodity price risks only up to a certain level. These limits hamper energy suppliers, for example, in forward selling their electricity production to a sufficient extent (via exchanges), or being able to buy emissions certificates required to produce electricity. Additionally liquidity of wholesale markets would be affected and also position limits would affect OTC physical forward reclassified as financial instruments (see answer 7).

EFET is in favour of position management supported by appropriate position reporting rather than position limits: we believe that regulatory supervision of positions is a sufficient measure to ensure the proper functioning of markets (see section on detailed comments).

The imposition of ex-ante position limits does constitute a measure of last resort and represents a severe market intervention. In this light, the imposition of position limits needs to be subject to additional conditions.

At the very least clear provisions to exempt risk management activities are needed. This can be done by defining that non-financial firms shall not be subject to position limits for those products used for risk management activities. As a reference please consider the definition introduced by the CFTC on “Bona fide Hedging and Other Exemptions for Referenced Contracts”3. This would also avoid the significant administrative burden for non-financial undertakings that have to justify the positions needed for risk management purposes (see section on detailed comments).

Also, the imposition of position reporting in real time on non-financial firms active as participants or members on regulated trading platforms constitutes excessive administrative burden. Indeed, only weekly reports with aggregate positions are required to be published, therefore, more proportionate arrangements have to be introduced, i.e. that the operators of these platforms will report on behalf of these firms and that market participants would be required to report on a weekly basis only positions in contracts not concluded through platforms (see section on detailed comments).

As part of the new arrangements it may be appropriate to specify more clearly the responsibilities of operators of regulated markets, MTFs and organised trading venues to ensure the positions taken by non-financial firms trading on their platforms do not undermine market integrity or create systemic risk.

28) What are the key interactions with other EU financial services legislation that need to be considered in developing MiFID/MiFIR 2?

The main financial services legislations that have interactions with MiFID/MiFIR 2 are the European Market Infrastructure Regulation (EMIR), the Capital Requirements Directive (CRD) and the Market Abuse Regulation (MAR). All these are currently under consideration in the legislative process.

There are potential overlaps between parts of these legislative initiatives and this situation may lead to uncertainties for market participants/operators that would ultimately result in an excessive increase of cost to be paid by consumers. Costs for margining obligations, collateralisation of transactions and compliance duties would impact on energy prices for end customers.

In particular we believe that MiFID should be based on provisions agreed in EMIR, when defining rules for non financial counterparties, otherwise the approach of the clearing threshold agreed in EMIR would be overridden.

Beyond the financial services legislation, interactions are foreseen with sector specific legislation in the energy market. In particular, the Regulation in Energy Market Integrity and Transparency (REMIT), which recently entered into force, introduced a single oversight regime for gas and electricity markets and market participants across the entire EU. REMIT includes rules on registration of market participants, prohibition of insider dealing and market manipulation, transaction reporting, monitoring and enforcement rules by National Regulatory Agencies supported by the Agency for Cooperation of Energy Regulators (ACER).

We urge the need to define clear boundaries between the different legislative reforms under discussion, with a clear definition of their scope in order to avoid at any time that the same issue is covered by several pieces of legislation.

29) Which, if any, interactions with similar requirements in major jurisdictions outside the EU need to be borne in mind and why?

We refer in particular to the rules concerning the energy sector included in the Dodd-Frank Act approved in the US. EFET strongly supports a better specification of the MiFID II perimeter to exclude from the definition of financial instruments all products with delivery in the future that are physically settled. This is the approach used in the US under the Dodd-Frank Act, and as such any departure from this in the EU would create regulatory inconsistency (see also answer to question 7).
Please find herewith some preliminary comments and amendment proposals to specific sections of MiFID II and MiFIR proposed by the EU Commission.

Please consider these as initial contribution to the legislative process. EFET will provide further and more detailed amendments in due course.

<table>
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<th>Detailed comments on specific articles of the draft Directive</th>
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<td>Article number</td>
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<td>Article 2.1</td>
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<th>Text proposed by the Commission</th>
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<td>(d) persons who do not provide any investment services or activities other than dealing on own account unless they</td>
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<td>(a) are market makers;</td>
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<td>(b) δ are a member of or a participant in a regulated market or MTF ï or</td>
<td>(b) δ are a member of or a participant in a regulated market or MTF as long as its activity does constitute algorithmic or high-frequency trading ï or</td>
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<td>(c) deal on own account δ by executing client orders ï outside a regulated market or an MTF on an organised, frequent and systematic basis by providing a system accessible to third</td>
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Parties in order to engage in dealings with them;

- This exemption does not apply to persons exempt under Article 2(1)(i) who deal on own account in financial instruments as members or participants of a regulated market or MTF, including as market makers in relation to commodity derivatives, emission allowances, or derivatives thereof; □

Article 2.1

The concept of “client of the main business” should be clarified acknowledging that:
- it is to be considered on a group basis.
- a client may become simultaneously client of the main business and to be provided with investment service i.e. the client does not necessarily have to be a client of the main business prior to receiving an investment service. This is necessary to avoid undue constraints when performing services in favour of customers of the main business.

Article 59

Clear provisions to exempt risk management activities are needed. This can be done by defining that non-financial firms shall not be subject to position limits for those products that are used for risk management activities. This would as well avoid the significant administrative burden for commercial undertakings that have to justify the positions needed for risk management purposes.

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<tr>
<td>1. Member States shall ensure that regulated markets, operators of MTFs and OTFs which admit to trading or trade commodity derivatives apply limits on the number of contracts which</td>
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any given market members or participants can enter into over a specified period of time, or alternative arrangements with equivalent effect such as position management with automatic review thresholds, to be imposed in order to:

(a) support liquidity;
(b) prevent market abuse;
(c) support orderly pricing and settlement conditions.

The limits or arrangements shall be transparent and non-discriminatory, specifying the persons to whom they apply and any exemptions, and taking account of the nature and composition of market participants and of the use they make of the contracts admitted to trading. They shall specify clear quantitative thresholds such as the maximum number of contracts persons can enter, **taking account of the characteristics of the underlying commodity market, including patterns of production, consumption and transportation to market.**

1a. The limits referred in paragraph 1 shall not apply to commercial undertakings that access Regulated Markets, MTFs and/or OTFs in order to manage exposures related to their groups commercial activities or comply with regulatory obligations, considering the characteristics of the underlying commodity market, including patterns of production, consumption and transportation.
<table>
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<tr>
<th>Article 60</th>
<th>Position reporting in real time on non-financial firms active as participants or members on regulated trading platforms constitutes excessive administrative burden in order to publish weekly reports with aggregate positions, therefore more proportionate arrangements have to be introduced.</th>
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<td>Text proposed by the Commission</td>
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<td>2. In order to enable the publication mentioned in point (a) of paragraph 1, Member States shall require members and participants of regulated markets, MTFs and OTFs to report to the respective trading venue the details of their positions in real-time, including any positions held on behalf of their clients.</td>
<td>2. In order to enable the publication mentioned in point (a) of paragraph 1, Member States shall require members and participants of regulated markets, MTFs and OTFs to report to the respective trading venue the details of their positions in financial instruments on a weekly basis, including any positions held on behalf of their clients, exclusively in relation to contracts that are not concluded through regulated markets, MTFs and OTFs.</td>
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<tr>
<th>Annex I, Section C</th>
<th>A revised definition of financial instruments excluding physically settled forward products is needed to avoid that physical trading is moved from today’s efficient broker platforms to bilateral trading. We believe that this development would be more likely than channelling of trades which are currently OTC onto organised venues.</th>
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<td>(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market ⊳,OTF, ⊳ and/or an MTF;</td>
<td>(6) Options, futures, swaps, and any other derivative contract relating to commodities that are not intended to be physically settled provided that they are traded on a regulated market, an OTF and/or an MTF;</td>
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<td>Article 24 New paragraph 2a:Article</td>
<td>The trading obligation procedure defined in MiFIR may reduce the scope recognised in EMIR. Additionally it doesn’t take into consideration the rules introduced for wholesale energy markets with the Regulation 2011/1227/EC on market integrity.</td>
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**Text proposed by the Commission**

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<td>2.a The obligation laid down in paragraph 1 shall not apply to wholesale energy products which are subject to appropriate monitoring by the competent prudential-supervision authorities as defined in Regulation 2011/1227/EC.</td>
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