

EFET response to CESR consultation paper on standardisation and exchange trading of OTC derivatives

EFET¹ submits the following key comments in response to this CESR consultation. Our answers to specific CESR questions are set out below, after these key comments.

- There are major differences between types of OTC derivative market; these relate to size, the underlying product, the diversity of market participants, the degree of geographic and product fragmentation, and the level of liquidity; this means, in the view of EFET, that no single regulatory solution is likely to be appropriate for all markets.
- EFET has been the initiator in 1998, and ever since the organiser, of European wholesale energy market contractual standards. From 2000 onwards EFET has worked on transaction process standardisation, including since 2005 electronic confirmation of transactions and steps towards electronic interchange of more complex transaction-related data. We note some milestones and challenges:
 - The EFET General Agreement for electricity and natural gas has become the predominant market standard for physically settled wholesale energy transactions in continental Europe. It is used not just for spot transactions, but also for future deals, which contain a physical delivery option but are often cash-settled in reality. Varying Annexes deal with power, specific gas hubs, carbon emission allowances, credit treatment etc. Such EFET master agreements have been translated into several languages, and have been instrumental in increasing liquidity in previously illiquid markets. Their existence facilitates a level playing field for big and small, old and new trading counterparties in some geographical markets long before the establishment of an exchange becomes feasible.
 - Further standardisation of documentation is hampered by existing differences in key legal aspects of contractual interpretation and enforcement between EU jurisdictions. Most problematically close-out netting provisions are not effective in some EU Member States. Here lies an opportunity for EU-led harmonisation, of a type which would better align practices in the OTC market with the advantages of cleared exchange trades. (See further our answer to question 5 below.) The EFET contractual standardisation work on credit support documents performed through our Legal Committee is paralleled by the work of an EFET credit group, discussing common standards for risk parameters and their implementation;
 - EFET defines and promotes process and transaction data standards for European gas and power traders. We have developed open IT

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 90 energy trading companies, active in over 27 European countries. For more information: www.efet.org.

standards and various modules offered by our subsidiary organisation, EFETnet, principally confirmation matching and more recently position and settlement matching;

- There has occurred a widespread roll-out of the EFET European electronic confirmation standard across nearly all the larger energy trading firms in Europe; the standard now covers high percentages of total wholesale power, gas and emission allowance transactions in a reliable way;
 - EFET has extended the scope of electronic standardisation to include settlement and counterparty positions, and lately exchange based transactions.
- EFET does not support mandatory regulatory requirements concerning contractual and transaction data standards. The benefits from industry led initiatives are significant in reducing legal and operational risk and in increasing efficiency. We anticipate that industry drivers will continue to provide sufficient momentum for improvements in OTC transaction standardisation, especially if policymakers and legislators will address opportunities for further EU corporate and contract law harmonisation. We see no justification for mandatory electronic confirmation or for any restrictions on the use of non-standard legal documentation. Energy suppliers, energy distributors and industrial energy consumers will continue to need tailor-made products (e.g. long term deals, special options, more complex price swaps) by the very nature of the variability and non-predictability of supply and demand conditions in the energy sector.
 - *Greater standardisation in OTC commodity markets is not a precursor to, or driven by, a need to prepare transactions for migration to exchanges as such, but rather harmonises the fungible, transparent and liquid qualities of OTC products with those offered by exchanges;*
 - EFET therefore believes that further commodity product standardisation should remain in the hands of the industry, taking into account the specific needs of each commodity market and the characteristics of the products. We agree with CESR that there are limits to standardisation and we welcome the provisional CESR conclusion that firms need to retain flexibility to customise products. This is particularly important for commodity trading firms, who access derivatives to help hedge commercial risk. In particular, we are concerned that mandated solutions could:
 - Actually increase risk, as commodity market participants seeking to mitigate specific risks through tailor made transactions would either find standard contracts could not adequately cover such risks, or would do so at a prohibitive cost. (For example, product standardisation could restrict hedging optionalities, only allowing certain amounts, dates or rates to be traded;
 - Reduce hedging activity, also having the effect of pushing up the overall level of risk in the commodity sector;
 - Incentivise dealers not to offer specialised contracts and/or increase their cost where available;
 - Have unhelpful effects on companies' balance sheets: standardised contracts make it extremely difficult for commodity firms to satisfy

hedge-effectiveness tests required under international accounting standards (e.g. FAS 133/IAS 39);

- Discourage industry from pursuing continued standardisation of processes (with a view to reducing operational risk also for structured products) and undermine the development of best practice as evidenced by the ongoing efforts of EFET and other associations.
- EFET welcomes the development of exchange trading, but it should not be an objective to supplant OTC markets. These are complementary and competing trading routes. Competition helps drive forward innovation and keep costs low. Forcing a particular market into a particular trading route, that has not been selected naturally, could lead to an inefficient outcome. In addition, given sufficient will, there are no barriers to realising the perceived benefits of exchange based trading (effective post trade transparency, use of clearing, process and legal standardisation) also in OTC markets.
- We support planned European initiatives with respect to reporting of standardised OTC derivative transactions to a trade repository, to help ensure there is effective market oversight of these markets. We would also support the publication of anonymous standardised OTC derivative transactions, to help ensure all interested parties have easy access to the same transaction data as active market participants. Improved post-trade transparency, though the publication of anonymous standardised transactions, may help with the development of robust price indices. The advent of increased post-trade transparency in OTC commodity derivative markets would mean that a lack of transparency should no longer be regarded as a justification for mandating exchange trading of these products.

In conclusion we want to remind CESR of our view that the lack of an EU netting regime is one of the most important obstacles to effective legal risk management.

Q1. Do you agree with CESR's assessment of the degree of standardisation of OTC derivatives? Is there any other element that CESR should take into account?

We generally agree with CESR's assessment of the degree of standardisation of OTC derivatives.

Q2. Do you agree with the benefits and limitations of standardisation noted above? Please specify. Can you also describe and, where possible, quantify the potential impact of the limitations to standardisation? Are there any other elements that should be considered?

We broadly agree with the description of the benefits and limits of standardisation. It is important to note that commodity trading firms also have a significant need to access non-standard derivatives to underpin efficient and effective risk management that reflect the particular physical nature of these markets.

Q3. Do you agree that greater standardisation is desirable? What should be the goal of standardisation?

We agree that greater standardisation is desirable – but this should primarily industry led as there is no evidence of failure in the commodity markets in developing innovative solutions in this respect that are tailored to the specifics of our markets. However, we reiterate our concerns about standardisation of products highlighted above – as such if there is any regulatory initiative it should focus on legal and process standardisation.

Q4. How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact?

EFET is committed to greater standardisation of processes and legal documentation for commodity transactions. We are happy to work with regulators to identify further improvements and best practice and to better understand the limits of standardisation in our markets. We also expect ESMA to play a role once it has been established.

Q5. Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.

Recently EFET work on developing standardised legal documentation for trading in energy products led to publication of a master netting agreement (MNA). The MNA functions as an umbrella agreement covering transactions under an EFET General Agreement or any other commodity master trading arrangement, allowing an overall close-out of a complete position between two counterparties, provided both counterparties make elections accordingly. This important development will further enhance the standardisation of the legal framework around commodity trading.

However as legal opinions, commissioned by EFET for all EU jurisdictions have proven, jurisdictions in most EU states do not, or not fully recognise the netting concept and ignore its enforceability in the crucial case of insolvency. EFET wrote to DG Market of the European Commission in 2008, suggesting an EU netting regime, acting together with other industry associations, notably ISDA. This EFET netting initiative has remained unanswered by the European Commission. The lack of an

EU netting regime is one of the most important obstacles to effective legal risk management. It would be helpful if an EU regime were developed, addressing current national barriers to a uniform netting solution for energy transactions capable of physical settlement (though cash-settled often in reality).

Q6. Should regulators prioritise focus on a) a certain element of standardisation and/or b) a certain asset class? Please provide supporting rationale.

We do not believe that OTC commodity derivatives should necessarily be a priority for greater standardisation given the current ongoing industry efforts in this respect.

We do not believe that bespoke physical settled energy transactions can be subject of “regulatory standardisation” in view of the existing deviations in national jurisdictions within the EU. Standardisation would require a more uniform civil law concept as well as uniform insolvency laws in the EU.

OTC energy derivatives are traded in much smaller volumes compared to other derivative products and have not contributed to the financial crisis nor have they carried potential for systemic risk.

Q7. CESR is exploring recommending to the European Commission the mandatory use of electronic confirmation systems. What are the one-off and ongoing costs of such a proposal? Please quantify your cost estimate.

EFET would not support the mandatory use of electronic confirmation systems. Commodity derivative markets are very diverse in terms of the types of market participants, and the diverse, often highly bespoke nature of commodity derivative contracts. This makes mandatory ‘electronification’ not a suitable objective. Requiring smaller market participants (large consumers, municipalities), dealing in lower volumes, and transacting contracts less frequently, to invest in IT systems in this context would impose a heavy compliance burden, with little benefit in terms of mitigation of systemic risk. These market participants play an important role in commodity markets, and must not be discouraged from participation by unnecessarily onerous requirements.

Q8. Do you agree with the assessment done by CESR on the benefits and limitations of exchange trading of OTC derivatives? Should any other parameters be taken into account?

EFET welcomes the development of exchange trading but it should not be an objective to supplant OTC markets as they are complementary and competing trading routes. Competition helps drive forward innovation and keep costs low. Organised trading venues have been growing, in terms of volumes, range of products offered, and the scope of services, without specific regulatory obligations upon traders to use these markets. We believe this trend will continue in the future and it would be counterproductive to mandate a particular trading route for commodity derivative markets. Forcing a particular market into a particular trading route that has not been selected naturally could lead to an inefficient outcome.

It is important to acknowledge the ongoing initiatives to increase transparency in OTC markets. EFET would like to see transparency standards for OTC markets that are similar to exchanges where appropriate, and where this provides useful information for the price formation process. OTC markets also provide the opportunity for non-financial firms, to choose how to manage their credit risk and this benefit should not be removed by regulatory action.

The UK Financial Services Authority and HM Treasury concluded in their December 2009 paper on reforming OTC derivatives markets, mandating the trading of standardised OTC derivatives on organised trading platforms is "unlikely to deliver the benefits which would warrant the costs of introducing such a policy proposal when regulatory objectives can be achieved by other means" (para 8.4).

Q9. Which sectors of the market would benefit from/be suitable for (more) exchange trading?

We doubt it is possible, or even desirable, to identify sectors of the commodity market, which are more suitable for exchange trading. Some commodity sectors have seen a significant increase in the role of exchanged based trading in the last few years. Over time markets will develop an optimal balance between the level of exchange and OTC trading, as long as this natural evolution is not constrained by barriers to market development. To the extent EFET observes any evidence of such barriers in European power, gas and emission allowance markets, it is inherent in our mission as a traders' federation to overcome them, and we are working hard with energy regulators, TSOs and other stakeholders to do so.

Q10. In your view, for which sectors of the market will increased transparency associated with exchange trading increase liquidity and for which sectors will it decrease liquidity? Please specify.

EFET believes that liquidity in energy markets will benefit from enhanced transparency across all trading platforms. This can be achieved in relation to OTC trading when appropriate levels of post-trade transparency are introduced for relevant derivative transactions; we would not then expect any significant differentiation between e.g. broker platforms and exchanges on this score.

Q11. Do you identify any other elements that would prevent additional OTC derivatives to be traded on organised platforms?

No. Exchanges have commercial incentives to introduce new products. The fact that they do not always do so is driven by their assessment of risk and return. We do not consider that it is necessary or prudent for regulators to change this process.

Q12. How should the level of liquidity necessary/relevant to exchange trading be measured?

It is not possible (or desirable) to identify a particular level of liquidity necessary for exchange trading – although there are a number of ways in which liquidity itself can be measured.

Q13. Do you agree with CESR's assessment of the characteristics and level of standardisation which are needed for a contract to be traded on an organised trading platform?

We do not have a view on this issue at this stage.

Q14. Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.

While availability of CCP clearing is essential for a commodity contract to be traded on an organised trading platform it is not the pre-determining factor. The commodity markets have numerous instances of OTC derivatives being centrally cleared. The Commission should take care not to confuse the separate processes of clearing and exchange trading. It is also important there is a sufficient liquidity and number of participants – but as mentioned above there should 'target' level of liquidity that should determine whether a product is suitable for exchange trading – rather it should be a natural evolution.

Q15. Is contract fungibility necessary in order for a derivative contract to be traded on an organised trading platform? If so, which factors would be necessary to achieve full fungibility, not only within the same market but access different execution venues? Please provide supporting rationale.

There are advantages in being able to create products which reduce or eliminate basis risk between products traded on different platforms or OTC. We consider that there are strong incentives for and evidence of the industry continuing to develop standard transaction documentation and definitions to reduce risk in this way.

Q16. Which derivative contracts which are currently traded OTC could be traded on an organised trading platform? Please provide supporting rationale.

As explained above we do not believe it is appropriate to mandate exchange based trading for OTC commodity derivatives. We would expect any industry initiative to start trading an OTC product through an exchange to result from extensive market consultation and to be driven by the needs of market participants.

Q17. Please identify the derivative contracts which do trade on an organised trading platforms but only to a limited degree and could be traded more widely on these types of venues.

We do not have a view on this issue at this stage.

Q18. In the OTC derivatives context, should any regulatory action expand the concept of "exchange trading" to encompass the requirements set out in paragraphs 86 and 87 or only the requirements set out in paragraphs 86? Please elaborate.

We do not have a view on this issue at this stage.

Q19. Do current trading models and/or electronic trading platforms for OTC derivatives have the ability to make pricing information (both pre-and post

trade) available on a multilateral basis? Please provide examples, including specific features of these models/platforms.

We do not believe there are any particular barriers to the provision of sufficient pre- and post-trade pricing information through existing platforms – although as explained above we support the introduction of a trade repository for the reporting of all OTC derivative transactions and publication of appropriate anonymous trading data.

Q20. Do you consider the SI-regime for shares relevant for the trading of OTC derivatives?

We do not have a view on this issue at this stage.

Q21. If so, do you consider that the current SI-regime provides the benefits described above which “exchange trading” may offer or are amendments needed to the SI obligations to provide these benefits to the OTC derivatives market?

We do not have a view on this issue at this stage.

Q22. Which characteristics should a crossing network regime, as envisaged in the review of MiFID, have or a crossing network to be able to be qualified as a MiFID “organised trading venue”?

We do not have a view on this issue at this stage.

Q23. In your view does the envisaged legislative approach in the US leave scope for regulatory arbitrage with the current EU legislative framework as provided under MiFID? Would regulatory measures taken in the EU to increase “exchange trading” for OTC derivatives help avoid regulatory arbitrage?

We do not see the scope for regulatory arbitrage between US and EU markets in relation to OTC derivatives for power, gas and emissions, given the strong link to the underlying physical transactions and the lack of a US traded emissions market.

Q24. The Commission has indicated that multi-laterality, pre-and post-trade transparency and easy access are key aspects of the concept of “on exchange” trading. Do you agree with CESR applying these criteria in its further analysis of what this means in the EU context, in particular in applying MiFID to derivatives trading?

As explained above, types of OTC derivative market are very different and an imposed solution will not suit all segments. Although we do not support mandated platform trading, if it is introduced it will be important to have as wide a definition as possible of what constitutes a qualifying platform, so as not to constrain routes to market and competition in platform provision. We see that proportionate and appropriate transparency and easy access can be achieved in OTC markets as well.

Q25. If not, do you consider that MiFID requirements and obligations should be refined to cover deviating characteristics of other electronic trading facilities? Please elaborate.

We do not have a view on this issue at this stage.

Q26. Are there any market led initiatives promoting “exchange trading” that the regulators should be aware of?

There are market led initiatives in Europe to set up power market coupling through implicit day-ahead auctions, which are facilitated through exchanges. Although not directly impacting on derivative transactions, the auctions help provide a robust price reference for futures.

Q27. Which kind of incentives could, in your view, efficiently promote greater trading of standardised OTC derivatives on organised trading venues? Please elaborate.

As explained above, we do not believe there is a need for regulatory incentives to promote greater trading of OTC derivatives through organised trading venues as this should be a market driven process.

Q28. Do you believe there would be benefits in mandatory regulatory action towards greater trading of standardised OTC derivatives on organised venues? Please elaborate.

We do not consider that it would be appropriate for regulators to mandate platform trading. Even where exchange platforms exist for particular products, there are legitimate reasons why market participants may wish to enter into bilateral transactions. OTC markets are an important competitor for (and are complementary to) exchange based offerings and we believe innovation would be restricted and costs would ultimately rise. Mandatory exchange based trading may also restrict market access for some non-financial firms – for example due to cash liquidity issues resulting from margining requirements. This would impinge on firms’ ability to manage commercial risk and reduce overall market liquidity. MiFID was designed to encourage such competition and we see no need to move away from the basis of an open market in the provision of execution models.