

EFET Response to Public Consultation by the Directorate General for Internal Market and Services on Derivatives and Market Infrastructures ("EC Consultation")

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.¹

Introduction:

EFET supports the European Commission's initiative to strengthen financial stability and to ensure efficient, safe and sound derivatives markets and we welcome this EC Consultation of the forthcoming Derivatives and Market Infrastructures Regulation.

When drafting and adopting the European Derivatives and Market Infrastructures Regulation ("EMIR") we urge the EC to consider the following issues:

We would like to stress the significant differences between wholesale energy firms / businesses and the traditional financial firms / businesses and demonstrate that wholesale energy trading firms do not give rise to issues of investor protection and financial stability. Consequently, a simple like-for-like application of financial markets regulation to the wholesale energy trading markets is not appropriate. Despite the clear assurances expressed in the earlier Communication COM (2009) 563/4 that the European Commission "*will take into account the specificities of certain commodity market e.g. electricity and gas markets*" (which was reiterated by the EU Council in December 2009²) it has not addressed these specificities

¹ For more information: www.efet.org

² : "*STRESSES [...] the need [...] to take into account differences across classes of instruments and contracts, as well as those of specific market participants, incl. non-financial firms, and commodity markets, e.g. for gas and electricity. Any future policy option should ensure that non-financial institutions can continue managing the risks inherent to their business, without incurring disproportionate costs; and where appropriate should allow them to tailor risks to individual needs [...]*." In: Council conclusions on Commission Communication on "Ensuring efficient, safe and sound derivatives markets - Future policy action" and on Commission report on "The Code of Conduct on clearing and settlement: Three years of experience", 2981st Economic and Financial Affairs, Brussels, 2 December 2009.

in its EU Consultation paper. Mandatory central counterparty (“CCP”) clearing will have a negative impact on electricity and gas markets and hamper the development of integrated and efficient European markets by reducing liquidity and the number of competitors and by creating financial liquidity and commodity risks for energy trading firms. This will undermine the objectives of the EU 3rd Energy Package. These factors are also likely to lead to lower investment (in order to cover the costs of central clearing) and feed into higher prices which will ultimately be paid for by end users.

In detail:

- **The financial crisis was not caused by non-financial energy trading firms active on the wholesale energy markets** (utilities, corporates, industrial end users, energy traders) but evolved from bubbles in the real estate and financial markets as well as highly complex securities (CDS, ABS, etc.). This view is also shared by the report of the European Parliament’s Committee on Economic and Monetary Affairs (Langen Report).³
- **There is no evidence that energy trading and the companies operating in this sector give rise to any systemic risk.** Unlike failures in the financial markets, the withdrawal of individual market participants does not result in any domino effect and market collapse. Energy traders operate on their own account and in case of failure no public intervention is required to ensure financial stability and the protection of investors. Because the utmost level of security of supply is required in the energy sector – which was never at risk at any point in time during recent and past crises – the power plants continued to operate. Hence, activities of energy trading firms in the financial markets have neither in the past created any systemic risk nor is there any reason to believe that they will in future. This view is supported by the Advice of the Committee of European Banking Supervisors (CEBS) which in its advice of 10th October 2007 to the EU Commission (CEBS-Advice)⁴ clearly stated that *“systemic risk concerns ... appear significantly smaller relative to the systemic risks posed by banks and ISD financial investment firms. In the commodities case studies*

³ Report of the EU Parliament on derivatives markets: future policy actions, 7.6.2010, page 5, ref. O: “whereas most derivatives used by non-financial end-users involve limited systemic risk taken individually, and for the most part serve merely to hedge real transactions, and whereas non-financial institutions are firms that do not come within the scope of the MiFID (non-MiFID firms), such as airlines, car manufacturers and commodity dealers, which have neither created a systemic risk for the financial markets nor been directly harmed by the financial crisis”.

⁴ Please see under: <http://www.c-ebs.org/getdoc/56ec266c-981c-4b95-93cf-103ab9f76b08/Commoditiesriskassessment10102007.aspx>.

examined in this report, systemic concerns were limited and contained.”⁵ The CEBS-Advice concludes that “it is unlikely that one participant in the energy trading market could cause the collapse of the energy industry, i.e. the production and distribution of energy commodities, despite this industry’s dependence on the respective commodities markets via its ‘natural’ positions. There were several notable bankruptcies in recent years involving key players in the energy markets but the impact on the energy industry overall has been limited (e.g. Enron, Transworld Oil, Gatt Oil).”⁶ This view is also shared by the Langen Report.⁷

- **Energy derivatives are supported by strong underlying physical markets, with prices driven by physical supply and demand.** Daily prices are determined by fundamental supply and demand. This daily or even hourly link to real supply is even more pronounced when it comes to electricity which in fact cannot be stored. Grids and power plants continued to function even when energy traders collapsed - due to sectoral regulation to ensure continuity and security of supply in the event of firm failure. On the contrary, behind financial companies and products there are no solid assets like commodities, power plants or grids.
- **Unlike participants in the financial market, many different companies operate in energy trading.** Apart from large players in the market (energy companies, large industrial consumers, oil corporations and banks), smaller trading partners like municipal utilities and retail companies also operate in the market. This results in a valuable market player diversity and therefore a lower level of market concentration which decreases the systemic risks.
- **A key motivation for politicians to opt for more regulation of the financial sector is the fact that many private investors risked to lose their savings in the banking crisis if the government had not intervened. However, this concept of consumer protection of this sort is not a concern valid in energy trading.** This is because the counterparties to energy trading transactions are generally professional traders and energy companies and not private customers. CEBS concluded that in most commodity markets there is very little direct private client participation and negligible direct contact between private clients and energy trading firms.⁸ Energy trading firms do not take deposits from the public and typically present no direct exposure to depositors. Unlike some financial institutions,

⁵ Please see CEBS-Advice, page 2, ref. 12.

⁶ Please see: CEBS-Advice, page 22, ref. 75; see also for the Enron case study: CEBS-Advice, page 31, ref. 122 et seq.

⁷ Report of the EU Parliament on derivatives markets: future policy actions, 7.6.2010, page 5, ref. O.

⁸ Please see CEBS-Advice, page 26, ref. 95 – 99.

energy trading firms do not offer commodity linked investment products to private investors.

- **The vast majority of energy trading firms primarily use derivatives for hedging and mitigating current and future risks arising from the physical nature of their underlying operational businesses.** Non-financial energy trading firms generally have a natural long (e.g. electricity producer is long with electricity) or short position (e.g. electricity producer is short with fuel and CO₂) in the underlying physical markets. This natural position creates an associated price risk which firms have to manage. Efficient risk management means that firms seek to hedge this price and commercial risk in the market through derivative products. By hedging a firm is essentially swapping this price risk for either credit risk (if it chooses not to clear) or cash liquidity risk (if it chooses to clear). Managing credit risk imposes a cost and as firms generally have the ability to control these costs they will decide on the most efficient balance between credit and cash liquidity risk when entering into new transactions. Mandatory central clearing removes this flexibility but it does not reduce the overall level of risk in the commodity sector. Instead, credit risk is essentially being swapped for cash liquidity risk. **This means that mandatory central clearing does not reduce the overall level of risk incurred by a firm but it does remove its ability to efficiently balance its price, cash liquidity and credit risks.** If firms are required to centrally clear their OTC derivative transactions it will impose a significant cost, prevent efficient risk management and it is not clear what benefits are realised. This is because there is no evidence of a generic problem in credit risk management in the energy sector that requires measures to remove the possibility of this risk from the system.
- **Real energy trading business is so diverse that the sole use of standardized energy derivatives will never fit in order to mitigate risk efficiently and effectively for corporates.** Amongst others this would jeopardize current hedge accounting practices and increase profit & loss volatility.
- **Mandatory clearing would have a negative impact on competition and liquidity in the energy sector.** It can represent an additional barrier to market entry and lead to a decrease in market participants. It will also force firms to increasingly run unhedged positions – which perversely will actually increase the level of risk in the sector.
- **In the light of these comments, EFET is of the opinion that non-financial energy trading firms should be exempted from clearing and margining (further reasons are provided in the following sections).** Such an exemption from the obligation to clear for

non-financial energy trading firms would not create opportunity for regulatory arbitrage or the possibility firms may seek to exploit this exemption. There appears to be a natural legal solution to this concern laid down in the current MIFID exemptions, namely that if an energy trading firm is part of a systemically relevant financial institution – the main business of which is the provision of investment services and activities or banking services – then this firm shall automatically be deemed as systemic without further assessment and obliged to clear. This boundary is already policed by regulators.

I. Clearing and Risk Mitigation of OTC Derivatives

- 1. Clearing obligation*
- 2. Eligibility for the clearing obligation*
- 3. Access to a CCP*
- 4. Non-financial firms*

Questions:

What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivative contracts for mandatory clearing, and its application? Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?

A) Exemption for non-financial energy trading firms

EFET is of the opinion that all non-financial wholesale energy trading firms should be exempted from clearing and margining for the reasons explained below:

- 1. Mandatory or incentivised central clearing for OTC commodity derivatives implies significant costs and negative consequences that outweigh potential benefits:**

- Energy trading firms would not enjoy a reduction in risk from a mandatory central counterparty (CCP) clearing as they can easily manage their counterparty risks by diversification (and have always done so without additional costs) and already have effective credit risk management processes and policies in place.
- Energy trading firms, while currently direct participants in energy derivative markets, are not typically CCP clearing members (with some occasional exceptions). Members of clearing houses are typically credit institutions or regulated investment firms. Thus, a regulatory push towards central clearing of commodity derivatives would either
 - Require energy trading firms to pay considerable amounts in initial and variation margin to be members of central counterparties; or
 - More likely, require energy trading firms to pay financial institutions for clearing services at central counterparties.

Either way, clearing would result in additional costs to energy firms and ultimately energy customers.

- Additionally to this, the current layouts of clearing agreements (concluded between non-clearing member, i.e. energy trading firm, and clearing member, i.e. banks) and the clearing rules of the biggest European commodity clearing houses are not protective enough for energy trading participants (in their role as non-clearing members) if the clearing member defaults. With regard to the huge amount of margins requirements (especially initial margin) and the significant daily cash movements (variation margin and other settlements) that effect would be worsened by mandatory clearing because the credit exposure would be even greater. Consequently, energy companies would run a much higher financial and close-out risk, in the case of a clearing member's default.
- We would like to stress the uncertainty especially of the amount of variation margin which an energy firm has to post as collateral at the segregated accounts of CCPs: This amount can change dramatically over a relatively short period of time (e.g. daily) because of the price volatility on the underlying markets. It is difficult to estimate the future impact of variation margin when first negotiating derivative contracts. Therefore the counterparties run substantial liquidity risks which they need to manage. Mandatory central clearing will significantly increase this cash liquidity risk for non-financial energy firms who will find it increasingly difficult (and expensive) to access funds to cover these costs – particularly in stressed market conditions – which will drive up the possibility of firm failures.

- Mandatory clearing is limited to the credit facility (i.e. the kind of collateral and definition of the VaR (value-at-risk) limit) accepted by the clearing member (i.e. financial institution) and forces the energy trading company to:
 - Reduce its position(s) and therefore limit hedging opportunities; and
 - Spread positions over different CCPs and losing then netting effects on variation or initial margin, which is contradictory to the intention of bringing all clearable OTC positions to clearing.
- Financial-institutions could easily net positions of different counterparties due to long and short positions and they have large portfolios qualifying as collateral (e.g. if requested by a CCP).
- Since most energy trading firms do neither have any collateral portfolios nor any direct access to central bank monies, they would thus need to borrow money from financial-institutions first in order to deposit it as collateral with the CCP before hedging their business risks.
- This would lead to an absurd and not practicable situation as neither financial institutions nor the capital markets would be willing or able to provide such an amount of additional liquidity needed, especially in periods of high stress in the financial market.
- Furthermore, energy trading firms', respectively, corporates' profitability and solvency would be negatively affected by weakened credit ratings, causing rising interest expenses and indebtedness, while financial-institutions would benefit from the system (as lender and arranger of capital market transactions).
- 'Incentivisation' of central clearing through higher prudential requirements for financial institutions or requirements to post more collateral for all market participants each in relation to bilateral, non-clearable contracts: This would create higher costs for OTC derivatives transactions which would incentivise market participants to avoid to trade on OTC markets with non-clearable contracts.
- The overall cost for EU energy trading business, in particular in respect of the requirement to post cash collateral at CCPs, is estimated to amount at least to a two-digit billion Euro figure.
- As a consequence of the resulting cash liquidity risks and/or other costs many energy trading firms would have to stop or at least reduce hedging and take price risks or would simply not be able to cover the costs as they lack access to the required liquidity.

2. Increase in energy prices and/or reduction of investments

The amounts of cash collateral resulting from the margining / collateralising requirements, which have to be posted on the segregated account of CCPs, would

- **Increase the price of power and gas for end consumers** in the EU as these cost would be passed on, and/or
- **Reduce to a substantial degree, if not prevent, necessary investments of the energy industry** into the energy infrastructure. This would damage Europe's energy production and supply capacity, because market participants feeling discouraged from making major investments by an inability to hedge the commercial risks they face in an economical or efficient manner – contradicting the development of single EU competitive energy market. By diverting working capital into margin accounts, a reduction of investments in the energy sector could affect future security of supply and the timely achievement of Europe's sustainability/renewable energy objectives

3. Central clearing is already in wide use in energy derivative markets and its use will most likely increase in the coming years as a result of market-led initiatives, so that there is no need to mandate CCP clearing for these markets:

Exchanges, trading platforms and clearing houses as well as energy market participants have shown themselves to be able in recent years at developing products meeting commodity market needs, including the need to limit counterparty (credit) risk efficiently. These initiatives have proved successful for commodity derivative contracts where sufficient standardization and liquidity facilitates central clearing. During times of financial system stress and higher general credit risks energy trading market participants have moved their trading portfolio during times of financial system stress and higher general credit risks voluntary to exchanges and clearing house (inclusive of CCP clearing of OTC derivatives). It is important to give market participants the choice between exchange and OTC markets as well as between CCP clearing and bilateral clearing to meet their specific needs for effective risk management and not impose damaging liquidity risks.

4. “One-sided” positions

Energy trading market participants trade commodities to manage their own business risks and to optimise the commodity delivery chain to underwrite “security of supply”. They use derivatives to reduce and hedge the risks embedded in their “natural” commodity exposures (e.g. a power producer is naturally “long” power and “short” fuel and CO₂ allowances) several years ahead into the future. Therefore, typically energy trading firms run flat or close to flat books when looked at in total, considering exposures resulting from physical supply and demand side activities and their hedging programmes. Hence, access to derivatives is primarily done for hedging purposes.

5. There is no apparent financial systemic risk caused by energy trading firms that requires a regulatory push of OTC energy derivatives contracts (to which energy trading firms are counterparties) onto clearing house is apparent for energy trading firms.

As explained above, we do not believe that there is a risk-based case of market failure to justify the regulatory movement of OTC energy derivatives on a grand scale onto CCPs. Indeed, as explained above, the energy market has not caused the recent financial crisis and is already evolving to manage risks efficiently and effectively – and should be allowed to continue to evolve in the absence of their contribution to the recent market failure.

6. The above-explained major differences between traditional financial firm / products and energy firms / commodities speak against a “one-size-fits-all” approach.

EFET does not believe that the single regulatory solution to mandate CCP clearing fits to the specifics of the wholesale energy trading business.

7. Gas and electricity market development would be hindered.

As main consequence we expect that many market participants will decrease their activity in the wholesale market. The mandatory CCP clearing poses a challenge that is an even

greater for companies of the Central and South-East European (CSEE) region than they do for those in Western Europe because countries in the CSEE region are mainly emerging market economies, which are mostly illiquid and not comparable to markets like Germany or Scandinavia. If the European Commission imposes very high levels of sophisticated regulation, especially in clearing, those markets will not develop more liquidity. In Western Europe, at least small and medium-sized companies would not access the market anymore directly, but rather via intermediaries, like investment banks. Also, compliance with CCP clearing would certainly deter newcomers from entering energy trading wholesale markets. This would reduce the number of direct counterparties in wholesale energy trading and reduce competitive pressure in the market. Other larger energy trading firms would significantly scale back their hedging activity leading to a further reduction in liquidity. There is also the concrete risk that energy companies use more complex non-standardised ways to hedge (e.g. through bilateral physical contracts) outside the standard derivatives wholesale market and as a result liquidity would even drop further.

8. Negative adverse effect on MiFID-exempted energy firms

The extension of the clearing obligation to certain physically-settled commodity derivatives may inadvertently subject energy firms previously exempted from MiFID to the obligations there under. This is because the CCP clearing of derivatives, especially the process of margining and the level of standardisation required for CCP clearing, may qualify these instruments as financial instruments within the meaning of MiFID (Annex 1 Section C items (7) and (10) to MiFID and Article 38 (1) of Regulation (EC) No 1287/2006).

9. Application to intra-group transactions

Based on the wording of the EC Consultation the clearing obligation and margining requirement would also apply to contracts entered into between counterparties that form part of the same group (intra-group contracts). This obviously not appropriate.

B) Information Threshold

EFET urges that any clearing and margining obligation should not apply to non-financial counterparties for the reasons already explained above (please see section I.A. of this response above, page 5 et seq.).

The EC Consultation leaves many questions around the information threshold open, which obviously need to be dealt with: The EC Consultation paper states that the information threshold “would be defined at a further stage taking into account the systemic relevance of the sum of net positions by counterparty per class of derivatives”. This statement raises many substantial questions: What means “at a further stage”, “systemic relevance”, “and sum of net positions”, “by counterparty”, and “per class of derivatives”. All of these terms are so essential to the application and effects of an information threshold that they need to be put into more concrete form. If were to be an information threshold, which gives sufficient clarity to market participants, EFET would be able to comment in more detail.

At this stage EFET would like to stress, that automatic and potentially arbitrary thresholds, which could result in significant costs and detrimental cash liquidity risk for non-financial firms, should not be used. Unless it can be demonstrated that a non-financial firm, through its participation in OTC derivative markets, gives rise to additional and unacceptable levels of systemic risk it should not be subject to mandatory central clearing and margining. Any such assessment cannot be quantitative alone and must be based also on qualitative criteria and specific to the characteristics of the energy market the firm is active in.

C) Clearing Threshold

EFET advocates that any clearing and margining obligation should not apply to non-financial counterparties for the reasons already explained above (please see section I.A. of this response above, page 5 et seq.). The additional shortcomings of this approach are explained further below in this section C.

The general approach on the application of the clearing obligation to energy trading firms (non-financial counterparties) that meet a certain clearing thresholds has too many shortcomings that are not acceptable:

- **The EC Consultation explains that the clearing obligation for non-financial energy trading firms applies automatically to energy trading firms if they breach a pure quantitative threshold.** The underlying regulatory idea is to opt-in only systemic important non-financial firms. For this reason EFET is convinced that there should be no clearing threshold at all for energy trading firms because they are not systemically important, i.e. we think there should be a full exemption for energy trading firms. If there is to be a "clearing threshold" the competent regulator should perform an individual assessment of the systemic importance of the relevant firm based on appropriate qualitative and quantitative criteria. This test should in particular seek to measure the degree of credit exposure of financial counterparties to the non-financial counterparty in question. We understand the need for a simple system to determine the systemic importance of an energy trading firm, however, consideration to simplicity must not lead to non-systemic important firms being captured by the clearing threshold. If – despite EFET initial comments on a clearing obligation for energy trading firms – it is found relevant to include energy trading firms in the clearing obligation, EFET would be happy to assist in the further development of a balanced system to assess systemic risk.
- **It is not appropriate that – as described in section I. 4. b) of the EC Consultation - an energy trading firm should clear the whole portfolio of its (eligible) transactions through a CCP if it breaches the clearing threshold.** We believe, if at all, that energy trading firms should only be obliged to clear the portfolio of eligible transactions at CCPs, which are above the clearing threshold.
- This approach does not take into account the size, financial standing or creditworthiness of each counterpart, but these are essential determinants for the underlying credit risks.
- **There is a danger that the automated clearing threshold is an excessively blunt instrument, on its own, which could lead to the inappropriate result that non-systemic energy trading firms have to clear their transaction at CCPs:**

 - In the event that a financial firm transacts with a non-financial energy trading firm, which does not breach the clearing threshold, the latter will also be subject to the obligation to clear.
 - The same is true in the event that a non-financial energy trading firm, which does not breach the clearing threshold, transacts with a non-financial energy trading firm, which is subject to the clearing obligation.
 - If that is the case, the exemption would be in effect meaningless.

- This would lead to the unintended consequence that non-financial counterparties would avoid to trade with financial firms.
- **There is the possibility that energy trading firms would tend to keep their energy trading portfolio below the clearing threshold and avoid to transact with financial firms**, respectively, with non-financial firms subject to the CCP clearing obligation in order to avoid the prohibitive costs of CCP clearing. This would reduce significantly the liquidity in OTC markets and expose these firms to commodity risks.

5. Risk mitigation techniques for non-cleared contracts

Question:

Do stakeholders share the principle and requirements set out above on the risk mitigation techniques for bilateral OTC derivative contracts?

EFET does not agree with the principles and requirements set out in the proposal. The imposition of the described mandatory risk mitigation techniques is not appropriate.

Energy trading companies already established effective risk management systems to handle the related counterparty and position risks including:

- The formal role of the Board in establishing a policy for managing credit risk,
- Establishing a framework of systems and controls for managing credit risk,
- Establishing practices and procedures for the effective assessment,
- Evaluation, measurement and management of credit risk (value at risk, mark-to-market...),
- Utilising credit enhancements,
- Mitigating credit risk through contractual documentation (Parent Companies Guarantees, Letters of credits, Master Netting Agreements, EFET master agreements including CSA, etc.).

In particular, energy markets participants, supported by the International Energy Credit Association, have worked together on drafting documentation and providing mechanisms to further reduce credit exposure; for example the EFET Agreement and its annexes. The legal framework, processes and controls have worked well and proved resilience – even during the financial crisis - because they were designed specifically for the energy market.

In addition, EFET would like to raise the following concerns against the imposition of the risk mitigation techniques for bilateral OTC derivative contracts as described in the EC Consultation:

- All non-cleared contracts would have to comply with these risk mitigation techniques. The obvious intention would be to incentivise clearing or to recreate a similar effect of clearing when a clearing service is not available or possible.
- We have great concerns about the approach because we think those requirements will most likely turn out in additional and severe cost burdens for risk management operations for energy traders.
- Most energy traders have in place robust and resilient processes to monitor the value of outstanding contracts, which ensure that credit risk is kept at an acceptable level. Nevertheless the proposal of the EC Consultation would require a full collateralisation approach. Requirements and risk mitigation techniques are proposed regardless of the risk profile of counterparties that enter in a transaction. Counterparty risk profile of an OTC derivative transaction is basically bilateral; hence the evaluation of default risk of the respective counterparty should be part of the process.
- We want instead to emphasize the negative effects on liquidity and the boost to procyclicality that can result from this approach.
- There should be no penalization of risk management activities. Energy traders should be encouraged to operate risk management transactions in an efficient way. It is in the interest of financial stability, investment activity, creation of jobs and securing future prosperity in Europe.
- Finally we want to emphasize that in the United States, where similar legislation is on approval, it has been recognized that *“if regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not*

unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth”⁹.

II. Requirements for Central Counterparties

- 1. Organisational requirements*
- 2. Risk Committee*
- 3. Conflicts of interest*
- 4. Outsourcing*
- 5. Participation requirements*
- 6. Transparency*

Questions:

Do stakeholders share the general approach set out above on organisational requirements for CCPs? In particular comments are sought on the role and function of the Risk Committee; whether the governance arrangements and the specific requirements are sufficient to prevent and manage potential conflicts of interest; stringent outsourcing requirements; and participation and transparency requirements?

EFET supports measures to increase robustness for financial market infrastructures, in particular provisions to enhance harmonization in the regulatory framework for CCPs. However, we think that costs for clients of direct clearing members should remain under an acceptable level.

Do stakeholders consider that possible conflicts of interests would justify specific rules on the ownership of CCPs? If so, which kind of rules?

⁹ Text from the Letter sent on June 30th, 2010 from the Banking and Agriculture Senate Committees’ Chairmen Christopher Dodd and Blanche Lincoln to the House of Representatives corresponding Committee’s Chairmen, Barney Frank and Colin Peterson.

7. Segregation and portability

Question:

Do stakeholders share the approach set out above on segregation and portability?

Rules on segregation and portability should not affect netting possibilities. At the opposite, methods for reducing the use of margin should instead be encouraged whenever this can be done without increasing systemic risk. We think that the joint clearing of different derivative products at the same CCP would improve the opportunity to net negative and positive exposures, and would increase the incentives for market participants to clear on a voluntary basis.

8. Prudential requirements

Questions:

Do stakeholders share the general approach set out above on prudential requirements for CCPs? In particular: what should be the adequate level of initial capital? Are exposures of CCPs appropriately measured and managed? Should the default fund be mandatory and what risks should it cover? Should the rank of the different lines of defence of a CCP be specified? Will the collateral requirements and investment policy ensure that CCPs will not be exposed to external risks? Will the provisions ensure the correct management of a default situation? Are the provisions above sufficient to ensure access to central bank liquidity without compromising central banks' independence?

We support the initiative to improve the robustness of core financial market infrastructures by strengthening standards for payment systems, securities settlement and CCPs. Nevertheless the prudential requirements outlined in the consultation paper would most likely have an impact on clearing members and thus on their clients, i.e. energy trading firms, increasing costs to access central counterparty services. In particular, EFET wants to highlight its concerns about some requirements proposed in the consultation paper.

Margin requirements proposed in the consultation paper should be sufficient to cover potential exposures that the CCP estimates to occur until the liquidation of the relevant

positions. The “99 per cent of the price movements rule” would imply the need to reserve cash for the worst case. We want to emphasize that the application of this rule would increase exponentially the liquidity risk also for market participants that make use of CCPs services on a voluntary basis.

With regard to **collateral requirements**, the definition of acceptable collateral as being “highly liquid collateral with minimum credit and market risk” would most likely mean that only cash will be accepted. This would affect credit facility services that are offered by clearing houses at present and would exacerbate the impact of the proposed reform. We urge therefore the European Commission to evaluate potential effects on liquidity risk and the incentive to boost additional pro-cyclicality that policies to strengthen requirements in collateralization could imply. As a possible solution the future EMIR could prescribe that also other collateral than cash collateral is permissible, such as governmental bonds and certain kind of securities.

The **Default** waterfall process as described seems to be reasonable. Nevertheless for purposes of the margin calculations it should be ensured that different local insolvency laws within the EU allow for close-out netting. This is the precondition for the net exposure calculation, which is the basis for margin payments. If insolvency laws do not allow for close-out netting, margins are to be calculated on the basis of the gross exposure, which significantly increases the cash/other security value needed.

9. Relations with third countries

Questions:

Do stakeholders share the general approach set out above on the recognition of third country CCPs? Are the suggested criteria sufficient? Do stakeholders consider that additional criteria should be considered?

The intention to allow a third country CCP to provide clearing services to entities established in the European Union is welcome. Thus EFET supports the *possibility* to clear derivatives through a third Country CCP. However, it would be positive if there is at least one EU-based CCP available to clear the same class of derivatives. Otherwise, an energy trader would have to use services from a CCPs established under another jurisdiction.

Do stakeholders agree with the extension of the clearing obligation to contracts cleared by third country CCPs to ensure global consistency?

III. Interoperability

- 1. Interoperability*
- 2. Managing risks arising from an interoperability arrangement*
- 3. Approval of interoperability arrangements*

Question:

Stakeholders' views are welcomed on the general approach set out above on interoperability and the principles and requirements on managing risks and approval.

Rules on interoperability between different CCPs should incentivise netting possibilities.

IV. Reporting Obligation and Requirements for Trade Repositories

- 1. Reporting obligation*
- 2. Requirement for Registration of a Trade Repository*

Questions:

What are stakeholders' preferred options on the reporting obligation and on how to ensure regulators' access to information with trade repositories? Please explain.

Do stakeholders share the general approach set out above on the requirements for trade repositories? In particular, are the specific requirements on operational reliability, safeguarding and recording and transparency and data availability sufficient to ensure the adequate function of trade repositories and the adequate protection of the data recorded?

We support the need for increased transparency and a better oversight for regulators, but we recommend that it shall be pursued in a cost-effective way.

Under Option A of the Commission's proposals on trade repositories, financial counterparties would report to trade repositories any OTC derivative transaction entered into by them, including those entered into with non-financial counterparties. We consider that these reports should generally be enough to enable the competent authorities to monitor for any potential systemic risks presented to the financial system by non-financial counterparties, without imposing separate and duplicative information and reporting obligations directly on non-financial counterparties.

EFET does not support Option B of the proposal which would require all financial and non-financial counterparties to report the details of "EU derivatives contracts" to trade repositories.

EFET recommends to the European Commission to take the following considerations into account:

- The European Commission should take into account the proposals from DG Energy concerning the reporting of standardised transactions (including OTC trade data). In any case, a forthcoming transaction reporting obligation for OTC trading activities should not duplicate the future transaction reporting obligation under DG Energy's intention to ensure transparency and integrity of wholesale markets in electricity and gas through specific energy sector legislation. It has to be made sure, that companies do not have to report the same information to several different "trade repositories". The administrative effort of the reporting obligation for companies has to be minimised.
- We believe that exchanges and other trade execution facilities (brokers, trading platforms) should be asked to report to trade repositories. An obligation on all counterparties to report transactions concluded would be inefficient, multiplying structures and costs. An obligation on trading facilities would instead preclude redundancy and mismatching and ensure harmonisation in the most efficient way.
- Moreover we think that only trades on standard products should be reported regularly. A reporting obligation concerning non-standard products would not be meaningful and

difficult to standardise. An obligation to store and to keep available this information to competent authorities in case of investigation should be sufficient.

- We insist on the importance for trade repositories not to publish commercially sensitive information which should be only accessible by duly authorised regulators.
- EFET urges that competent authorities should not have the powers to impose ongoing transaction and position reporting obligations on non-financial counterparties whose positions exceed the information threshold (if it were to be adopted). In the context of the envisaged set-up of trade repositories, trade repositories can report the relevant transactions directly to competent authorities.

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