

EFET response to
public consultation on a revision of the Market Abuse Directive (MAD)
(23.07.2010)

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.

Introduction

EFET appreciates the European Commission consultation process to revise the Market Abuse Directive (“MAD”)¹. We provide in this introduction some general remarks and focus in the rest of our response on more detailed observations and solutions relating to energy commodities and commodity derivatives.

EFET supports the principle that existing shortcomings and gaps in the regulatory framework should be removed in order to provide a structure that will support the development of markets with a high level of integrity. However, financial market legislation (including MAD) has been conceived specifically for the objective of ensuring stability and integrity, as well as investor protection, in financial markets and it shows inconsistencies with the specifics of the energy sector.

Therefore, 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, we strongly oppose any simple like-for-like application of financial markets regulation, including of MAD, to the wholesale energy trading markets without taking into account the specifics of the energy sector. If the specifics of the sector are not properly taken into account liquidity and market integration will be reduced and barriers to entry will increase. This will undermine the EU Commission’s energy liberalisation objectives.

In this context we highlight that DG Energy has launched on 31st May 2010 a parallel consultation “*on measures to ensure transparency and integrity of wholesale markets in electricity and gas*”. It is necessary that this regime is considered in reviewing the MAD. A coordinated approach is crucial to avoid inconsistency and overlapping regulation. In this context we appreciate that DG Market mentioned in its consultation paper that “... *CESR and ERGEG also recommended a tailor-made market abuse framework in energy sector legislation for all energy and gas products not covered by MAD. DG ENER is currently consulting on such a regime which could ensure the entire electricity and gas sectors are covered by appropriate market integrity rules including an EU-level market monitoring function. The specificities of gas and*

¹ Directive 2003/6/EC of the European Parliament and of the Council (in the following also referred to as “MAD”).

electricity markets will also be relevant to gas and electricity derivative markets covered by the MAD.”

Our key concern in the European Commission’s current consultation is the proposal to change the definition of inside information and the extension of MAD to MTF and OTC markets in relation to energy commodity derivatives.

The change in definition of inside information could have significant unintended consequences – including in the physically traded energy markets – that would undermine asset based trading. This is because it could effectively prohibit asset owners making use of any information associated with their assets that may have a significant impact on prices (both on the derivative and the underlying asset) before it is released to the market. If firms cannot use such information, it would prevent them from optimising their asset portfolio; this would lead to inefficiency and ultimately higher prices to consumers. It would also significantly undermine the incentives to invest in further infrastructures. Commodity (derivative) products are fundamentally different to other financial products in that they are supported by strong underlying physical markets, with prices driven by physical supply and demand. Daily prices are determined by fundamental supply and demand factors. This daily or even hourly link to real supply is even more pronounced when it comes to electricity which in fact cannot be stored. In our view these physical characteristics mean that it is not appropriate to strive for consistency in the definition of inside information for commodity derivatives with other financial products.

The proposed measures could also prejudice the work of DG Energy in seeking to establish a sector specific approach to transparency and market integrity.

The EU Commission also highlights the issue of better investor protection as a driver for the change in the definition of inside information and extension of MAD to MTF and OTC. We do not believe this is a relevant consideration for the energy sector. 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.² Energy trading firms do not take deposits from the public and typically present no direct exposure to depositors. Unlike some financial institutions, energy trading firms generally do not offer commodity linked investment products to private investors.

² Please see CEBS-Advice, page 26, ref. 95 – 99.

(1) *Should the definition of inside information for commodity derivatives be expanded in order to be aligned with the general definition of inside information and thus better protect investors?*

In addition to the comments above, EFET endorses fully the description of the shortcomings of MAD as described in the ESME-Advice³ and the CESR-ERGEG Advice on Market Abuse⁴ and would like to highlight in particular the following issues:

- The MAD makes reference in its definition of financial instruments to commodity derivatives and other instruments admitted to trading on a regulated market in a member state but does not further define or explain these legal terms (see the seventh and last indent of article 1(3) MAD). The same is true for the Level II implementing measures of the MAD and also some of the national market abuse regimes implemented. In contrast, Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments (“MiFID”) defines in Annex I Section C no. 5-7 the scope of the term commodity derivatives and a further class of other non-financial derivatives, such as derivatives linked to weather, emissions allowances, freight rates and economic statistics (here referred to as “exotic/hybrid derivatives”)⁵.
- These derivatives are further defined in articles 38 and 39 of Commission Regulation (EC) No. 1287/2006 implementing MiFID (the “MiFID Regulation”) and form a sub-category of the broader definition of “financial instruments” contained in article 4.1(17) MiFID. If the Commission, as part of its review of MAD, looks again at the definition of a derivative we propose to align it to the MiFID-definition and urge it to take account of US legislation “Dodd-Frank Wall Street Reform and Consumer Protection” that clarifies that the definition of a swap should not include:
 - “(i) any contract of sale of a commodity for future delivery (or option on such a contract), ...”; and
 - “(ii) any sale of a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled;...”⁶

This regulation clarifies that all physically settled transactions are not categorized as derivatives. Differences here between the US and EU could distort markets.

- The *general definition of insider information in MAD*⁷ is ill-suited for commodity markets because insider information in the terms of this definition are those events

³ See attached Advice by the European Securities Markets Expert Group on commodity derivatives business (“ESME-Advice”), p.102 et seq.; see under: http://ec.europa.eu/internal_market/securities/docs/esme/commodity_derivatives_en.pdf.

⁴ CESR and ERGEG advice to the European Commission in the context of the Third Energy Package Response to Question F.20 – Market Abuse – of October 2008 (Ref: CESR/08-739 – “CESR-ERGEG Advice on Market Abuse”), ref. 58; see under: <http://www.cesr-eu.org/popup2.php?id=5270>.

⁵ See MiFID in its Annex I Section C no. (10)

⁶ See Title VII - Wall Street Transparency and Accountability -; Subtitle A - Regulation of Over-the-Counter Swap Markets; Part II - Regulation of Swap Markets -; sect. 721 (a). Final version available at <http://thomas.loc.gov/cgi-bin/query/F?c111:6:./temp/~c111XVqIMH:e817>:

⁷ The term inside information is defined by Art.1 No.1, first sub-paragraph of MAD in conjunction with Art.1 of the Directive 2003/124/EC of 22 December 2003 implementing MAD. Art. 1 No. 1

which do not have a specific significance for the commodity/energy trading market, the prices of commodities and commodities derivatives etc., but do apply rather in general to all businesses.⁸

- Inside information in relation to commodity derivatives is defined in MAD as *“information of a precise nature which has not been made public, relating, directly or indirectly, to one or more such derivatives and which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets”*⁹. The CESR-ERGEG advice¹⁰ concluded on this that *“the commodity derivative specific definition of insider information in MAD is difficult for securities regulators to apply, in the absence of a clear definition of the information that users of commodity markets can expect to receive in accordance with accepted market practices on those markets”* and in particular concerning the energy sector that *“the information the users of energy markets can expect is not specified in legally binding provisions and/or is not precise enough. This uncertainty makes the prohibition of insider trading in commodities derivatives difficult to apply for securities regulators in some EU jurisdictions”*¹¹.

In the energy sectors this lack of clarity for market participants are in the process of being resolved through a number of channels: The recently agreed 3rd Energy Package includes detailed transparency requirements in relation to energy infrastructure; Member States have recently agreed binding detailed guidelines in relation to transparency on gas transmission networks; ERGEG is in the process of reviewing fundamental data transparency requirements in power and gas and will advise DG Energy of remaining gaps in the coming months.

EFET believes therefore that detailed and precise requirements in relation to transparency for the energy sector will be brought forward under the existing 3rd Energy Package and DG Energy’s proposed market integrity regime. Therefore, there is no need to duplicate insofar an inside information definition for energy commodity derivatives in MAD or at least it should be aligned to DG Energy’s market integrity regime.

MAD: “Inside information’ shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.”

⁸ Such insider information is, for example, equity measures, integration, conversion, squeeze-out processes and other substantial structural transformation measures, conclusion of a control and/or profit and loss transfer agreement; take over, tender or purchase offers; dividend payments; change rating; acquisition or disposal of principal investments.

⁹ Art. 1 (1) MAD – the definition is supplemented by Art. 4 of Directive 2004/72/EC: “For the purposes of applying the second paragraph of point 1 of Article 1 of Directive 2003/6/EC, users of markets on which derivatives on commodities are traded, are deemed to expect to receive information relating, directly or indirectly, to one or more such derivatives which is: (a) routinely made available to the users of those markets, or (b) required to be disclosed in accordance with legal or regulatory provisions, market rules, contracts or customs on the relevant underlying commodity market or commodity derivatives market.”

¹⁰ CESR-ERGEG Advice on Market Abuse, page 4.

¹¹ Please see CESR-ERGEG Advice on Market Abuse, ref. 58.

EFET urges that the EU Commission acknowledges the needs and specificities of the underlying physical energy business when reviewing the insider dealing and market manipulation prohibitions. Many of these prohibitions are not meaningful in the commodity and commodity derivatives business and should not continue to apply in our view without substantial amendments. As explained above, EFET asks DG Market to take into account the future market integrity regime of DG Energy for the underlying physical energy markets. There should be an EU level playing field and any contradiction or overlap should be avoided. Any forthcoming market abuse regime under MAD needs to respect the principles of better regulation, in particular should be appropriate and proportionate in the light of its aims. Hence, a right balance between the interest of market transparency / market integrity on the one hand and the legitimate interest of market participants and on the other hand of a still emerging EU energy wholesale trading market needs to be respected. In this context, we ask the EU Commission to consider justified interest of asset owners and operators and of security of supply.

(2) Should MAD be extended to cover attempts to manipulate the market? If so why? Is the definition proposed in this consultation document based on efficient criteria to cover all cases of possible abuses that today are not covered by MAD?

EFET believes that the extension of the prohibition of market manipulation to *attempts* would be acceptable as long as the definition of attempt is precisely identified and regulators will still have to prove that the behaviour was intended to have that effect. We are concerned that the definition as set out in the consultation document should require the party (or parties) accused to provide evidence demonstrating the legitimacy of their actions; in particular the second part of letter (a) *“unless the person who entered into the transactions or issued the orders to trade establishes his reasons for doing so are legitimate and that these transactions or orders to trade conform to accepted market practices on the regulated market of multilateral facility concerned”*.

We strongly believe that regulators will still have to bear the burden of proof that certain behavior was intended to have a particular effect.

(4) To what extent should MAD apply to financial instruments admitted to trading on MTFs?

EFET agrees that there is a regulatory gap in such form that the MAD does not apply to commodity derivatives traded at MTFs and on OTC markets¹². This raises the question of whether there is a need to extend MAD to trading activities on MTFs and OTC markets – which essentially is an issue of whether market integrity would be improved (i.e. it remedies a market failure), whether it would be a proportionate regulatory response and if were practicable.

EFET is of the opinion that an extension of MAD to MTFs and OTC markets would need to be justified on the basis that it is a remedy to a significant market failure and

¹² Please see for details EMSE-Advice, pages 111 – 112.

would be a proportionate regulatory response. In this context, EFET urges that the EU Commission performs a full Cost-Benefit-Analysis and Impact Assessment.

EFET would also like to point out that the extension of MAD's market abuse regime should take into account the current level of market integrity at MTFs and, if at all, only extend to the necessary degree. Indeed current obligations/rules imposed on MTFs ensure a certain level of investor protection, market transparency and market integrity at MTFs:¹³ Art 26 (1) and (2) of MiFID requires investment firms and market operators operating an MTF to monitor transactions undertaken on the MTF in order to identify conduct that may involve market abuse and to report the conduct to their competent authority. The operation of MTFs is an investment service, which needs to be licensed under MiFID (Art. 5 of the MiFID) and needs to fulfil certain organisational and conduct-of-business rules of MiFID. In addition, the trading process on MTFs itself is subject to MiFID regulation (Art. 14 of the MiFID), which provides e.g. for trade transparency. Moreover, the insider dealing and market manipulation regime may also apply to any financial instrument (commodity/exotic derivatives) not admitted to trading on a Regulated Market in a Member State, but whose value depends on a financial instrument traded on a Regulated Market.¹⁴

EFET believes that a fully developed market abuse regime, which is designed for Regulated Markets, could be disproportionate for certain MTFs because of important compliance costs and could hamper further market development. For example, MTFs can be set up by any party, at any time and can be very limited in size – and as such a general extension of MAD to all MTFs could constitute a disproportionate regulatory response creating barriers to efficient and effective operation of markets. This could discourage small and medium sized trading firms from operating an MTFs or trading at an MTF and, consequently, have an adverse effect on energy trading markets generally, e.g. in terms of liquidity.

Furthermore, EU Commission plans to extend prohibitions of market manipulation also to any financial instrument not admitted to trading on a regulated market or an MTF in a Member State, but which can have an impact on the value of a financial instrument admitted to trading on a regulated market or on an MTF. EFET would like to stress that this would have an adverse impact on participants of the energy markets, as the whole set of MAD market integrity obligations would become applicable, such as the disclosure regime and it could also be a disproportionate response for OTC markets.

¹³ Please see for more details EMSE-Advice, pages 112 – 113.

¹⁴ See Art. 9 subparagraph. 2 of the MAD: “Articles 2, 3 and 4 shall also apply to any financial instrument not admitted to trading on a regulated market in a Member State, but whose value depends on a financial instrument as referred to in paragraph 1”