

EFET RESPONSE TO EC CALL FOR EVIDENCE ON EU REGULATORY FRAMEWORK FOR FINANCIAL SERVICES

■
31 January 2016

Introduction

The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We currently represent more than 100 energy trading companies, active in over 28 European countries. For more information, visit our website at www.efet.org.

Summary of main points

EFET fully supports the timing of this consultation and the objectives of the European Commission (EC) to ensure the regulatory framework for financial services and markets remains fit for purpose. This can be achieved with a framework that strikes an appropriate balance between continuing to underpin fair, efficient and effective markets while supporting growth and employment – both in financial and related physical (commodity) markets.

Since the 2008 financial crisis, significant regulatory reforms have already been implemented, with further initiatives yet to be finalised and put in place. While the functioning of financial markets has become more robust and transparent there is now a much more complex and interrelated regulatory regime. This has brought significant additional costs for firms and impacted the efficient and effective operation of markets.

Financial (and underlying physical) commodity markets have been particularly affected by the development of this comprehensive and overlapping regulatory framework. This has come at a time when liquidity and participation in commodity markets has been falling. Those who remain active in commodity (derivative) markets make up a very diverse population of firms. Some access commodity derivative markets only periodically to hedge their business risks, while others have a continuous presence across a range of commodity product classes, potentially for both hedging and proprietary trading. The comprehensive nature of the regulatory obligations faced by this diverse population of firms may need to be recalibrated in certain areas to ensure an appropriate balance is struck between ensuring a robust regulatory framework and the burden faced by firms.

Many firms that are active in commodity derivative markets are also present in wholesale physical energy markets. The EC has pursued greater liberalisation and integration of EU energy markets through a series of legislative initiatives – most recently the ongoing implementation of the Third Energy Package. The EC has also implemented REMIT which has put in place a regime for transparency and market integrity in physical power and gas markets.

The legislative reforms in the energy market have led to greater competition, investment and more efficient markets. However, there are real risks to the successful completion of the internal energy market that are posed by the ever increasing complexity and burden of the

framework of financial market regulation. There has not been sufficient assessment of the economic consequences for physical commodity markets and their participants in the pursuit of a more comprehensive financial regulatory framework. The interaction between physical and financial markets is significant and it is crucial that the EC understands how reforms cut across the different sectors.

Our responses to the specific questions in the consultation are set out below – but there are also some additional issues which should fall under the scope of this review:

- **Increasing use of Level 2 measures to implement legislation and governance arrangements around related regulatory Q&A** – as the regulatory framework has become more complex there has been an increasing tendency for significant elements of the implementing arrangements to be defined in a range of Level 2 legislative measures. While it is recognised that it is not possible or appropriate to develop detailed implementing rules in Level 1 legislation it is crucial that any related legislation that is proposed remains consistent with the overall agreement reached by the co-legislators.

The development of Level 2 legislation often identifies significant technical implementation challenges that were not clearly understood at the time the Level 1 legislation was agreed. These issues can impact the ability of firms to fulfil their regulatory obligations in the implementation period available. An example of this was the development of the implementing rules for transaction reporting under EMIR. As the true complexity of the reporting arrangements became clear it was apparent that both the ability of all firms to report accurately and of Trade Repositories to receive and process data were not going to be of sufficient robustness for go-live.

EFET would therefore urge the EC to consider the development of a more flexible regime for implementation (and management of the Level 2 legislation) along the lines in the US where the regulator (the CFTC) has the ability to provide ‘no action letters’. This regime has the effect of allowing a greater degree of pragmatism in implementing complex regulatory requirements without the need to change the agreed legislation. Any such arrangements developed in the EU would need to have appropriate checks and balances to ensure there are no unnecessary delays in implementation.

We have also seen an increasingly tendency for significant issues of implementation to be delegated to guidance provided by regulators. For example, the EMIR Q&A is over 120 pages long and contains key guidance to firms on how to implement EMIR. Some of this guidance fundamentally impacts the costs incurred by firms, the compliance strategy adopted and the operation of markets. . While EFET supports the use of Q&A to provide clarification to firms there is a need for a robust governance process around how any changes are managed. Regulators now have the ability to change the Q&A with no consultation or consideration of the potential impact on firms. At the very least there should be a minimum consultation period for any changes of substance. Regulators should also establish consultative working groups with industry to work more closely together to identify when changes will lead to significant impacts.

Regulators must also ensure that Q&A is not used as a vehicle to implement requirements that are inconsistent with the Level 1 or Level 2 legislation. They should also review Q&A to assess whether any aspects need to be moved up into Level 2 legislation to provide sufficient regulatory certainty to firms; and

- **Need for prescriptive guidance from regulators on new obligations** – to ensure effective implementation of new regulatory requirements without incurrance of unnecessary costs there is a need for regulators to provide prescriptive guidance in certain areas. This allows firms to develop systems and processes that are fit for purpose and can be implemented in a cost effective way. It is recognised that it is not ESMA’s role to prescribe particular technologies or implementation solutions – this should be left to the discretion of firms – but the regulator must be clear about the obligations faced by firms particularly where IT, system or process driven solutions will be required.

It is not appropriate, as with EMIR transaction reporting, that ESMA publishes clarifications on reporting in the form of Q&A the night before the reporting obligation goes live.

There remain areas where regulators need to be more prescriptive in what has to be reported by firms under EMIR – including the generation and dissemination of UTIs and on the validation rules being applied by TRs. In other areas, where there is sufficient details on what should be reported, regulators have not taken action to ensure that all firms are following the guidance that has been provided (e.g. on how to report exchange traded derivatives). This means that a very significant proportion of EMIR transaction reports submitted by market participants will not match completely – which creates a significant compliance burden for the whole industry. EFET urges the EC to direct ESMA to take the necessary steps to ensure that all firms are reporting in line with the regulatory requirements. EFET would also support a requirement to rectify breaches in a specified time period (longer than 48hrs if double-sided reporting is retained for ETDs).

EFET response to the EC consultation questions:

1. ***Unnecessary regulatory constraints on financing: Please identify undue obstacles to the ability of the wider financial sector to finance the economy, with a particular focus on SME financing, long-term innovation and infrastructure projects and climate finance. Where possible, please provide quantitative estimates to support your assessment.***

Together the regulatory provisions under CRD IV and CRR have resulted in a significantly more selective assessment of credit risk by lending banks leading to restrictions in credit availability particularly for some small and mid-cap companies. This is a clear and direct impact of Basel III rules and we believe the EC should look at how to ensure the supply of credit to real economy companies is maintained at a level that will support further investment in growth and employment.

For larger companies, a lower interest rate environment has temporarily mitigated the pricing effects of increased regulatory costs and as such additional solvency and liquidity costs have not yet been fully reflected into the pricing of loans and credit facilities. Another key development is the disappearance of so-called “*swingline*” facilities (i.e. facilities which enable a borrower to draw on funds on the same value date, in case of a liquidity swing or urgent event requiring such reduced drawdown notice) within multilateral or bilateral facilities: such emergency drawdowns are key

items in securing liquidity requirements for number of companies and their treasury positions. Again, this is a direct consequence of stronger liquidity requirements for such lending commitments (i.e. lenders are now unwilling to provide these facilities).

In addition, a number of commodity trading entities are (fully or partially) licensed “investment firms” (as per MIFID definition) and thus subject to a variety of financial regulations, including the prudential regime requirements (CRDIV/CRR). Within this category, some licensed commodity dealers are (i) subject to a light (Member-State specific) prudential regime, e.g. UK Chapter 3 rules applying to UK metals and soft commodity firms, (ii) fully subject to the current prudential regime or (iii) can benefit from some exemptions.

Any capital that a large, licensed European energy trading company has to set aside to meet its regulatory capital and liquidity requirements in order to support its business as regulated entity, will no longer be available within wider industrial group to which it belongs for investments in other innovative (i.e. CO2 neutral or renewable energy sources) and/or other large infrastructure projects. In this respect, it should be noted that energy and transport sectors are considered key dimensions of the Single Market and that the European Commission has asked the energy sector substantial investment efforts over the coming years to implement the energy transition, around EUR 200 billion annually in the next decade¹. Imposing uncalibrated and excessive financial regulation to real economy firms creates an undue burden to finance long-term innovation and infrastructure projects.

2. Market liquidity: please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity. Please elaborate on the relative significance of such impact in comparison with the impact caused by macroeconomic or other underlying factors.

As highlighted in our introduction there is now a real risk that the EC’s objectives for both the single energy market and environmental markets are being negatively impacted by the ever increasing complex and burdensome framework of financial regulation.

EFET supported the development of a more comprehensive and robust regulatory framework in response to the financial crisis. However, there is a now a need to review whether all of the regulatory requirements remain appropriate particularly given their impact on markets. Some issues that should be reviewed in this context are outlined below.

One of the key objectives of EMIR was to reduce the amount of credit (and systemic) risk prevailing in the financial system. A comprehensive set of reforms were implemented to achieve this objective despite the fact there was no evidence of systemic (or unsustainable levels of credit) risk in the commodity sector. Indeed by ‘favouring’ cleared markets over OTC markets the overall level of risk has not been reduced – but rather transformed from credit to cash liquidity risk (as a result of the

¹ “Energy Union Package “ A framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy”, p.8: “The transition towards a more secure and sustainable energy system will require major investments in generation, networks and energy efficiency, estimated at some EUR 200 billion annually in the next decade.”

imposed margin requirements associated with cleared trading). Cash liquidity risk is arguably harder for firms to manage (particularly smaller players) and cleared markets do not provide the same product flexibility as is available in OTC markets. The more restrictive collateral arrangements associated with cleared trading are leading smaller non-financial counterparties to cease direct participation in the market. This increases market concentration and reduces liquidity, which ultimately results in higher costs for hedging. These are clearly unintended consequences which are contrary to the objectives of EMIR.

A direct result of the implementation of EMIR has been a significant contraction in the size of the OTC commodity derivative market. ^[4] OTC markets were viewed with suspicion by policy makers after the financial crisis – but they are now equivalent to cleared markets in terms of their regulatory oversight, transparency and robustness. OTC markets provide a crucial and flexible route to market for all firms to manage their risks in an efficient and effective way. EFET urges the EC to look at ways in which the OTC market in commodity derivatives can be allowed to grow in a sustainable way.

In developing regulatory requirements it is crucial firms are permitted both sufficient time to implement new obligations but also time to react and adjust their business models to the new regulatory framework. Despite numerous representations to ESMA and the EC, the implementation of the clearing thresholds under EMIR contained a very significant aspect of retrospective regulation. As such, firms were effectively penalised for commercial decisions that had been taken even before the financial crisis emerged. This is not effective regulatory policy making. Firms must have the opportunity to take key commercial decisions about their business in light of changes to regulation. They cannot be penalised going forward for decisions that were taken under the previous regulatory framework. To do otherwise only serves to undermine confidence in the regulatory framework and exacerbate the impact of unintended consequences – particularly on market liquidity and efficiency.

Unfortunately, the most recent proposals from ESMA on the commodity ancillary exemptions under MiFID II contain significant aspects of retrospective regulation. The EC should ensure that, in finalising MIFID, the same mistakes as under EMIR are not repeated.

There is now a review pending for the development of potential prudential capital requirements for (MiFID licensed) commodity firms under the CRD/CRR. The EC must ensure that any requirements (particularly any which are quantitative) are balanced against the objective for investment, growth and employment. To do otherwise could lead to unnecessary significant costs for commodity firms which will impact the extent of their activity in markets with resulting consequences for market liquidity. There is no evidence that any commodity firm poses a systemic risk to the financial system² and as such quantitative capital requirements will have a direct impact on the ability of firms to continue to invest and support business development.

MiFID II requires the establishment of position limits on all commodity derivative contracts. While this requirement is specified in the Level 1 legislation significant

^[4] The proportion of commodity derivatives decreased from 0.5% (H2-2009) to 0.3% (H2-2014) of the global derivatives market. Source: Statistical release OTC derivatives – Bank for International Settlement (www.bis.org).
² “Systemic risk in the energy sector – Is there a need for financial regulation” Marco Kerste, Matthijs Gerritsen, Jarst Weda, Bert Tieben. Energy Policy 78, December 2014.

aspects of the regime will be outlined in the relevant implementing measures. Although the level at which position limits will be set is an issue for determination at national level there is a clear need to ensure that they do not constrain liquidity in commodity derivative markets. The liquidity of trading in many commodity derivative contracts is limited – particularly in long dated maturity contracts and in less developed regional or product markets – and imposition of overly constraining position limits will only serve to constrain liquidity. .

In addition, there is a need to ensure that the arrangements for claiming hedging exemptions under position limits are transparent and easy for firms to use – ideally utilising some form of web based process – in order to minimise the challenge of managing differences in national regimes across the EU. Information required for applying for hedge exemptions should be relatively standardised and there should be a defined period of time for assessing application that does not impinge on firms' ability to efficiently hedge their business risks. All submissions must be permitted to be submitted in at least the English language and regulators should establish effective communication arrangements for any changes in position limits. Badly designed arrangements will increase the compliance burden for firms and potentially lead them to restrict trading in certain markets and/or contracts.

Other aspects of the position limit regime could also have a negative impact on liquidity and the ability of firms to efficiently and effectively hedge their risks:

- *Overly restrictive netting rules* - the removal of the ability to net non-MiFID and MiFID instruments does not recognise fundamental market dynamics as MiFID instruments are frequently used to manage physical risk and are recognised as fungible for risk management purposes. Netting across similar contracts with different maturities should be allowed.
- *Aggregation rules* - that require the aggregation of positions taken by subsidiaries or separate businesses operating within a group on an extra-territorial basis imposes a significant compliance risk for firms that will be managed by overly restricting trading activity. It is likely that the separate subsidiaries will not be subject to common oversight of their trading activity and will have distinct risk management and trading systems. This means managing aggregation of activity across commonly traded commodity contracts will be very difficult and lead to firms imposing unnecessarily tight restrictions on trading activity in order to manage aggregate positions.

One key issue which could have a significant impact on liquidity and the ability of firms to finance themselves is the potential financial transaction tax (EU FTT) – COM(2013)71. The implementation of an EU FTT would undermine the attractiveness of the taxation area deeply impacting non-financial companies. This taxation would have considerable negative direct and indirect effects on the financing of the real economy (especially long-term financing, hedging and intragroup management activities).

An EU FTT would also affect the liquidity and prices of non-financial companies' equity, as well as of other financial instruments used to hedge corporate risks, to manage the pensions of their employees and former employees and to manage their treasury/liquidity. Moreover, the return from treasury/liquidity management could be

affected to the point of stifling the money market and the repo market. The absence of exemption from intragroup transactions would further increase the tax burden and greatly reduce the necessary flow of liquidity within groups.

The consulting firm Oliver Wyman studied the impact of the proposed EU FTT on end users and highlighted two effects that have been underestimated (« *Impact of the EU 11 FTT on end-users* », 2013):

- Cascading taxes paid in the financial system are too large to be absorbed by the financial system and so would in large part be passed on to end users; and
- Reduced liquidity in the system would increase transaction costs for end-users.

Corporates would face annual costs of EUR 8 - 10 billion, equivalent to 4 - 5% of post-tax profits in the impacted economies ; investors would face a one-off decline in the value of their investments of 4 - 5% (equivalent to a EUR 260 - 340 billion decline in asset values). Additionally, they will face annual costs of EUR 5 - 15 billion in increased risk management costs.

Matheson analysed existing literature on financial transactions taxes and came to the conclusion that such taxes create many distortions that militate against using taxes to raise revenue (« *Taxing Financial Transactions: Issues and Evidence* », IMF Working Paper, 2011): increased cost of capital for issuers, reduction in trading volume and market liquidity and inefficiency in regulating financial markets and preventing bubbles.

As a general rule it is crucial that a cost-benefit analyses be conducted (and taken into account) before proposing new regulations that may have harmful effects on the liquidity of the market. This should become a key criteria of any assessment of new (or changes to existing) regulation.

- 3. *Investor and consumer protection: please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on investor and consumer protection and confidence.***
- 4. *Proportionality/ preserving diversity in the EU financial sector: are EU rules adequately suited to the diversity of financial institutions in the EU? Are these rules adapted to the emergence of new business models and the participation of non-financial actors in the market place? Is further adaptation needed and justified from a risk perspective? If so, which, and how?***

No, EU (financial) rules are not adequately suited to the diversity of financial institutions in the EU. Financial regulation (such as e.g. the CRR/CRDIV prudential regime framework) applies to both credit institutions and investment firms, including licensed commodity dealers; whereas such regulation is generally based on internationally agreed standards for credit institutions only without considering the

differences and characteristics of other financial actors, such as licensed commodity dealers.

Good regulation means that rules should be commensurate with the nature, scale and complexity of the underlying risks associated with an institutions' business model and activity. This has also been recognized by the EBA in its recently issued "Report on Investment Firms" (EBA/Op/2015/20), in which the latter recognizes the lack of flexibility and complexity of the current prudential regime.

Commodity firm do not pose systemic risks to the financial system and do not provide investment services to, and do not deal with non-professional retail clients, and therefore are not subject to sudden demands for large cash outflows in stressed conditions as is the case for credit institutions. Thirdly, commodity dealers generally have access to stable and diversified financing.

5. Excessive compliance costs and complexity. Please identify and justify such burdens that, in your view, do not meet the objectives set out above efficiently and effectively. Please provide quantitative estimates to support your assessment and distinguish between direct and indirect impacts, and between one-off and recurring costs. Please identify areas where they could be simplified, to achieve more efficiently the intended regulatory objective.

EFET supported the need for more transparency in derivative markets and improved access to trade information to regulators that has been established by EMIR. However, it is now the right time to review whether the full suite of obligations under EMIR should apply to all firms and all derivative transactions. There are some clear areas where the regulatory burden could be reduced without impacting on the level of transparency and robustness in derivative markets – as follows:

- Small firms i.e. those that throughout the year trade less than a certain number of derivative contracts should be exempted from reporting. In this case the counterparty trading with them will still report its side of the transaction. If both firms are below the certain threshold they would both be exempted. Transactions should be retained and provided on request to ESMA;
- A single sided reporting process should be established for exchange traded derivatives (ETDs). The non-reporting counterparty should be allowed to amend the information reported by the CCP or the clearing broker/bank within reasonable time-frame;
- Intragroup derivative contracts should also be exempted from regular reporting; however those contracts should be made available upon the request by ESMA or NRA. Any trading between the group entities reflects the risk mandate that entities have. The result of such trade is transfer of risk within the group which is pre-hedged or hedged afterwards in the market; and
- Assessing the merits of the compression procedure does not provide any benefits to the counterparties with respect to management against the clearing thresholds: therefore, we believe compression is an unnecessary requirement which, although assessed, is only rarely ever completed.

Although this is not a crucial requirement we advise to remove the obligation for firms to assess whether compression is necessary.

There are also other aspects of EMIR that have not been adequately implemented by regulatory bodies or the EC and which give rise to additional (and unnecessary) compliance risks and costs for firms – as follows:

- **Lack of equivalence decisions related to third country regulatory regimes** - the absence of equivalence decisions, particularly for the purposes of clearing and margin requirements, could put the international operations of many firms at a competitive disadvantage by requiring, for example, that margin be posted and collected multiple times. Such an outcome would harm not only banks but their clients too, many of which are major European corporates that make significant contributions to outbound and inbound trade and investment flows from Europe to non-EU markets.

It is essential that the Commission works closely with other regulators in third countries to develop plans for equivalence;

- **Lack of publication of a list of non-EU regulated markets that are considered equivalent.** Under MIFID I, unless the EC has determined a regulated market based in a third country as equivalent, derivatives traded on that regulated market by EU counterparties will be considered OTC derivatives, rather than exchange-traded derivatives. The EC has yet to deem equivalent any third country regulated markets under Article 19(6) of MIFID. This is particularly problematic for non-financial counterparties (NFCs) that trade on third country regulated markets, as those exchange-traded derivatives will now count towards the clearing threshold in EMIR even though the transactions are executed on cleared markets; and
- **Removal of the frontloading obligation in cases of mandatory clearing** - the obligation to frontload creates significant pricing and market risk challenges for firms. Even if the classes of derivatives that will be subject to the clearing obligation during the frontloading window are known in advance by counterparties market participants will be unable to accurately price those trades that will be cleared at a later stage.

6. ***Reporting and disclosing obligations. In some areas, however, the same or similar information may be required to be reported more than once, or requirements may result in information reported in a way which is not useful to provide effective oversight or added value for investors.***

Please identify the reporting provisions either publicly or to supervisory authorities, which in your view either do not meet sufficiently the objectives above or where streamlining/clarifying the obligations would improve quality, effectiveness and coherence. If applicable, please provide specific proposals.

Reporting obligations

EMIR and MiFID II both require reporting: EMIR on transactions and MiFID on both transactions and positions. Consistency should be sought between reporting obligations to avoid any duplicative reporting.

MIFID II position reporting: the rules applying to licensed commodity dealers are not yet clear and burdensome but and complex obligations apply to the reporting of trading venues positions and EEOCT contracts on behalf of clients up to the end client. This does not only pose issues in terms of compliance with privacy laws and banking secrecy. But also from an operational point of view, getting timely the accurate info up to the end clients will be extremely difficult, time-consuming and very labor-intensive requiring material IT developments to manage such data-heavy obligation. The majority of the required information has already been reported to trade repositories under EMIR and regulators should access the information they require from the TRs rather than there being additional obligations imposed on the market.

As mentioned in our introductory statements and under section 5 above, many issues remain to be tackled and/or could be simplified under EMIR reporting in order to reduce reporting complexity.

Disclosure obligations

An inconsistency in disclosure obligations that will lead to an unnecessary compliance burden are the requirements for the disclosure of inside information concerning emission allowances under the Market Abuse Regulation (MAR). ESMA's final advice on the MAR Regulatory Technical Standards impose an unnecessarily prescribed route for disclosure of inside information concerning emission allowances. Firms that are active in physical power and gas markets have already established effective and transparent routes to disclose inside information in relation to these markets. EFET believes the appropriate approach is to harmonise all information disclosure requirements for Emission Allowance Market Participants (EAMPs) under MAR to the arrangements already developed and in place under REMIT and explicitly stipulate that any disclosure made under REMIT is sufficient for MAR purposes in respect of EAMPs also within the scope of REMIT.

There is a clear need to remove this inconsistency as it would effectively put in place duplicative reporting for those markets that are already covered by REMIT. This, however, would be in conflict with the 2nd paragraph of Recital 20 and Article 25(3) of MAR which makes clear that authorities should take into account REMIT when looking at financial instruments that are wholesale energy products. Similarly, Recital 51 of MAR explicitly states that disclosure obligation should not lead to duplicative reporting with substantially the same content.

To ensure effective, timely and cost-efficient disclosure of inside information concerning EAMPs, it should be confirmed that:

- Relevant disclosure by market participants on national and/or regional REMIT transparency platforms is sufficient to also comply with the MAR requirements;
- A dual approach for disclosure of inside information consisting of both central platforms and on market participant's website as described in the ACER Guidance on the application of REMIT is compliant with MAR; and

- Only in cases where issues are covered by MAR but *not* covered by REMIT the procedures specifically related to MAR shall be followed.

7. Contractual documentation. Please indicate where digitalization and digital standards could help to simplify and make contractual documentation less costly, and, if applicable, identify any obstacles to this happening.

8. Rules outdated due to technological change. Please specify where the effectiveness of rules could be enhanced to respond to increasingly online-based services and the development of financial technology solutions for the financial services sector.

9. Barriers to entry. Please document barriers to market entry arising from regulation that the EU should help address. Have the new rules given rise to any new barriers to entry for new market players to challenge incumbents or address hitherto unmet customer needs?

The cumulative impact of regulatory requirements (both in financial and energy markets) now facing firms is beginning to create barriers to entry and undermine the ability of existing firms in the market to continue to sustain their current levels of activity. Commodity firms now have to report all transactions executed; perform portfolio reconciliation exercises and meet other obligations to manage operational risk; monitor themselves against the relevant regulatory thresholds and limit activity or face significant additional obligations and costs; manage themselves against commodity derivative position limits; have compliance arrangements in place for dealing with MAR and REMIT. This is without the potential additional capital requirements that could result from the forthcoming review of CRR/CRD.

Financial market regulation is beginning to create a three way squeeze on firms: there are now high costs of entry to markets which are incurred regardless of the level of activity undertaken; there are increasingly higher ongoing costs of doing business (which increase with the amount of activity) and can distort firms' decisions and ability to efficiently and effectively hedge their risks; and restrictions on the amount of activity before significant additional obligations (and costs) are incurred which limit the ability of firms to establish sustainable commercial platforms in light of the rising regulatory costs.

The EC should consider how it can alleviate one or more aspects of this squeeze to help better facilitate market development and liquidity, and continued investment in growth and employment.

10. Links between individual rules and overall cumulative impact. Please identify and explain why interactions may give rise to unintended consequences that should be taken into account in the review process. Please provide an assessment of their cumulative impact. Please consider whether changes in the sectoral rules have affected the relevancy or effectiveness of the cross-

sectoral rules (for example with regard to financial conglomerates). Please explain in what way and provide concrete examples.

The linkages between regulatory rules and their consequences are manifested in three main ways:

- **The interaction between financial regulations within the EU** – the interaction between different pieces of legislation under the broad umbrella of financial regulation is now very complex. While particular pieces of legislation or regulatory requirements may have differing objectives there is a need to fully understand any interactions to ensure policy measures are appropriate and proportionate and do not lead to unintended consequences.

For example, under EMIR there is a restriction on the amount of non-hedging activity in OTC derivative markets that firms can engage in before being required to centrally clear all of their derivative transactions (hedging and non-hedging across the corporate Group). This restriction will be supplemented by two policy measures under MiFID II that will impose additional restrictions on the amount of non-hedging activity in commodity derivative markets: the commodity ancillary exemption and position limits on all commodity derivative contracts.

This means there will be a ‘triple lock’ across EMIR and MiFID on the amount of non-hedging trading in commodity derivatives firms can engage in before becoming subject to significant (and costly) regulatory obligations. This will impact liquidity and participation in commodity derivative markets as many firms will decide to limit their activity accordingly. This will have knock on consequences on the ability of all firms to access commodity derivative markets at a reasonable cost to efficiently hedge their risks.

The Commission therefore needs to fully understand the interaction between all aspects of the regulatory framework (and in particular between MiFID II and EMIR) in order to avoid any duplication and to alleviate, where appropriate, unnecessary requirements that will impinge on the development of more liquid and efficient markets;

- **Interaction between the regulatory frameworks in different jurisdictions** – as reform of financial regulation has been implemented across different jurisdictions this has brought the issue of extra-territoriality and the interaction of regulatory frameworks to the fore – particularly for firms that operate across more than one jurisdiction. It is recognised that delivering a set of global regulatory reforms is complex and that there will be differences in approach as solutions are developed for local markets. While this is not necessarily a problem it does lead to additional compliance costs for firms. As such, the EC should ensure that unnecessary inconsistencies are avoided particularly in financial (commodity) markets that operate at an inter-regional or global level.

What is more problematic is where there is a level of extra-territoriality in EU legislation that creates an unsustainable overlap with the legislative and regulatory framework in other jurisdictions. One key example is EMIR: firms have to count their global commodity derivative activity against the (EU based) EMIR

clearing threshold.³ All jurisdictions have now reformed their financial regulation framework consistent with the objectives of the G20 commitment. Although reforms are not completed everywhere (and are not identical) we are not aware of any significant gaps that justify continuance of the current extra-territoriality reach of EMIR.

As (commodity) markets become increasingly globalised, the risk of unnecessary overlaps and inconsistencies between the regulatory frameworks in different jurisdictions becomes greater. The EC must ensure that any future initiatives carefully consider this issue to ensure that regulatory measures put in place are fit for purpose; and

- **Interaction between physical and financial market regulation** – physical and financial commodity markets are intrinsically linked. As such, regulation in financial markets can have a significant impact in the underlying physical market – particularly where requirements are inconsistent or duplicative.

Energy is subject to detailed regulation at both EU and national level. While energy and financial regulators generally have arrangements in place for coordination the EC should place an obligation on regulators and itself to demonstrate that policy or legislative measures fully take account of the interaction between sectors.

An example is highlighted above in answer to Q6 – the interactions between disclosure rules for inside information under REMIT and MAR.

It should also be noted that commodity dealers would need a clear recognition under MIFID II level 2 texts that Financial Transmission Rights (regardless with whom they are transacted and regardless it concerns primary or secondary market FTRs) should not be qualified as financial instruments. Long-term supply contracts and corresponding long-term transmission rights are essential energy markets' features to ensure cross-border trade and delivery of reliable energy for customers. To cover the risks of changing conditions between the contracting and delivery of such contracts, market participants hedge themselves through Physical Transmission Rights (PTRs) or Financial Transmission Rights (FTRs) auctioned by TSOs and traded on secondary capacity market. We currently observe a shift towards the use of Financial Transmission Rights instead of Physical Transmission Rights by several TSOs (e.g. IT, DK, BE). In some cases, PTRs have been abandoned and only FTRs remain available to market participants. This could trigger extra costs in terms of observing financial regulation and negatively affect the liquidity of secondary markets if FTRs are considered as financial instruments under MiFID II.

³ This is best illustrated by taking an example of a NFC- group that has a separate legal entity within the overall Group operating in another jurisdiction. For example, if the entity in the non-EU jurisdiction (say in the US) enters into a non-hedging OTC derivative transaction (by providing a hedging service to a *local* power producer or municipality/utility company) it is necessary to count this trade against the calculation of the Group position against the EMIR commodity derivative clearing threshold. In this instance, a transaction which: is regulated under the general provisions US law; is entered into by two US entities; has no impact on the EU market as it is related to local (and not global) markets; is already subject to the Swap Dealer thresholds under Dodd-Frank will count towards the EMIR clearing thresholds.

11. Definitions: Please indicate specific areas of financial services legislation where further clarification and/or consistency of definitions would be beneficial.

The definition of OTC derivatives (article 2.7 EMIR) should clearly mention that derivatives given up for voluntary clearing at an EMIR approved CCP after execution, should not be considered as OTC derivative. The underlying credit risk has been fully mitigated and therefore there is no reason to count such transactions anymore against the clearing threshold.

The definition of "group" (article 2.16 of EMIR) and of "intragroup transactions" under EMIR, should be aligned and not be two different concepts which complicates interpretation and proper implementation. In addition, this definition should be aligned to the definition of a Group in MiFID II and be updated with the most recent account Directive.

A major problem here is the non-recognition of a trade as an "intragroup trade" if entered into between an EU entity and a non-EU entity, belonging to the same group, in case the EC has not adopted an equivalence decision according to article 13(2) EMIR. As a result, these trades cannot benefit from a number of intragroup exemptions.

12. Overlaps, duplications and inconsistencies. Please indicate specific areas of financial services legislation where there are overlapping, duplicative or inconsistent requirements.

As explained above the most significant area where inconstancy of policy objectives can arise is at an overarching level, i.e. where the objective of energy market liberalisation is being impacted by financial market regulation or where growth and employment opportunities are being unduly restricted.

However, there are specific examples at a more detailed level where policy outcomes appear to be inconsistent. Under EMIR there is a requirement on clearing members to post additional margin in the event the activity of them (or their clearing clients) represents a certain proportion of the relevant market (to manage 'concentration risk'). These enhanced margin requirements for clearing members will be passed on to their clients and can mean that significant additional cash liquidity requirements are faced by firms that are trading on cleared traded markets. This creates an incentive on firms to potentially restrict trading in cleared markets.

There is a clear need to ensure that regulatory requirements are not duplicative or impose unnecessary compliance burdens on firms. EFET understood the objective of policy makers to ensure a more comprehensive regulatory framework following the financial crisis. However, this objective brought a significant number of firms into the scope of financial regulation for the first time with various requirements under EMIR.

13. Gaps. Please indicate to what extent the existing rules have met their objectives and identify any remaining gaps that should be addressed.

We see an important gap in the MIFID II Implementing texts related to the calculations under the ancillary activity exemption test. We are concerned by the

current absence of reliable data which will prevent market participants assessing themselves against the commodity ancillary exemption.

Therefore we urge ESMA to take immediate steps to make market size data for each commodity asset class publically available, either through collating information from the trade repositories (TR) and publishing it on ESMA's website or through requiring the TRs to make the information available on their websites.

EMIR should be amended to include an obligation for Trade Repositories to publish reliable, consistent and freely available EU market size figures in each of the relevant commodity asset classes.

14. Risk. EU rules have been put in place to reduce risk in the financial system and to discourage excessive risk-taking, without unduly dampening sustainable growth. (...) Please indicate whether, how and why in your view such unintended consequences have emerged.

Please see our comments in response to questions, 2, 3, 4 and 8.

15. Procyclicality: Please indicate whether some rules have unintentionally increased the procyclicality of the financial system and how.