Europex response to Commission's call for evidence on overall financial services reform

Europex welcomes the Commission's call for empirical evidence and concrete feedback on the EU's overall regulatory framework for financial services. Reflecting the interests of exchange-based wholesale markets for electricity, gas and environmental products, the Europex response mainly focuses on the specificity of wholesale energy trading.

Wholesale energy trading is in many ways different from traditional financial markets. Energy market participants use energy trading for mitigating their price risk along the value chain (sourcing, production, storage and retail-business). This is a common and important commercial practice and constitutes a necessary prerequisite for ensuring stable and affordable energy prices for the real economy and final consumers. Moreover, there is a significant difference between most of the energy trading firms and purely financial entities. Non-financial energy market participants (e.g. utilities) pose no threats to deposits, raise no issues of investor protection and have no access to central bank liquidity. Applying strict rules on financial services, such as MiFID II/MiFIR, to the electricity, gas and emission allowance markets without making a sufficient distinction, would therefore not only be disproportional to the intended policy objectives, but would also contradict the general aim of further integrating EU energy markets. In order to meet the EU's energy and climate objectives (ensuring a secure and sustainable energy supply at a competitive price), both, liquidity and market diversity, are crucial.

Against this background and in the context of the ongoing discussion on MiFID II Level 2, Europex supports the possibility for companies to calculate their overall activity based on capital employed. This will avoid that a large number of firms will need to obtain a MiFID II license, even though their activity in commodity derivative markets is by any reasonable assessment ancillary to their wider group business. In addition, Europex calls for a level playing field between market venues offering trading in energy derivatives, as the significant financial and organisational requirements following from MiFID II are expected to lead to a major liquidity shift to non-regulated markets. Such a shift is contrary to the G20 and EU objectives of creating safer, more efficient and more transparent financial markets, and needs to be reversed. Finally, Europex recommends streamlining the different reporting requirements under EMIR, MIFID II and REMIT. The overall efficiency and the data quality of the reporting mechanisms would significantly improve, if data was to be transmitted to only one collecting entity.

A. Rules affecting the ability of the economy to finance itself and growth;

1. Unnecessary regulatory constraints on financing

- The EMIR rules on the authorisation of new products (cf. Art. 15 of EMIR) and improvements to CCP risk management models (Art. 49 of EMIR) should be streamlined in order to allow investors to choose from a wider range of innovative risk management products as a means to hedge their investments or diversify their portfolios.
- Currently, it can in some cases take a CCP close to or even longer than one year to get a new product approved. Moreover, to approve new products or authorise an enhanced version of the CCPs' risk models sometimes lead to a situation where the same verifications are made more than once. Furthermore, it is open to the national competent authority's interpretation whether a change to a CCP risk model is defined as 'significant' and hence requires approval. In order not to hamper innovation, we call for one clear and official procedure equally applied across the EU and a clear definition of the role of each regulator in the procedure. It further has to be clear what the regulator considers to be a significant change to a risk model.

2. Market liquidity

- The next few years will show the impact of the yet to be finalised MiFID review on the liquidity of commodity markets, in particular with regard to energy commodities, such as electricity and gas. With the aim to avoid/minimise a significant decrease in energy market liquidity, Europex would like to highlight the following points in relation to MiFID II / MiFIR and other financial legislation:
- Heavy regulatory requirements under MiFID II (and hence CRD IV/CRR, EMIR, MAD II/MAR) as a consequence of trading on Regulated Markets (RMs) are likely to lead to a shift of traded volumes to non-regulated markets and an overall decrease in market liquidity in exchange-traded commodity derivatives. This would be contrary to the G20 Pittsburgh commitments of promoting more transparent, non-discriminatory and systematically safer markets. Referring to [our response to the EC's public consultation on the review of MiFID I] (11 February 2011), we consider that a level playing field for MiFID trading venues – RMs, MTFs and OTFs - is an essential prerequisite for true competition as well as for avoiding regulatory arbitrage. The type of the trading venue should therefore not be used as a basis to determine whether an energy commodity derivative contract is a financial instrument or not (cf. our response under "Definitions"). Revised legislation should focus on re-establishing a level playing field between the trading venues in this respect.
- Europex has been calling for appropriate thresholds with regard to determining whether a company's energy trading activity is to be considered ancillary to its main business and hence falls outside of the MiFID II scope or not. Importantly, the fewer contracts are covered by the financial instruments definition, the more difficult it becomes for companies still trading in financial instruments to stay below the threshold set by the ancillary activity exemption (which is calculated on the basis of the amount of traded financial instruments). Hence, we consider it a serious risk that

market participants will decide to leave the financial instruments market altogether and switch to trading in non-financial instruments instead.

- As regards the main business test of the ancillary activity exemption, we support that the capital employed for carrying out the ancillary activity relative to the capital employed for carrying out the main business should be considered. This will avoid that a large number of firms are being brought into the scope of MiFID even though their activity in commodity derivative markets is, by any reasonable assessment, ancillary to their wider group business.
- An important example of MiFID II regulation threatening liquidity in derivative contracts and hence an efficient price formation, is the positions limit regime currently proposed by ESMA. If position limits are applied throughout the whole period during which the contract serves as the front month, it will not be possible anymore for contracts to quickly evolve into benchmark contracts, as limits would be constantly breached. For certain product groups, this will incentivise significant regulatory arbitrage. Moreover, applying position limits throughout the whole month would be inconsistent with international best practices in France, the UK and the U.S., where position limits apply at the moment when delivery obligations take effect, i.e. when a future contract expires. We therefore call for amending the timing of the application of spot month position limits so that position limits for spot month contracts shall only apply during the last three days before the delivery of the contract**.** Europex is currently gathering data on the impact of changing the position limit regime accordingly.
- VAT fraud in gas, electricity and emission trading constitutes an important risk to the well-functioning of the energy markets, able to cause a major negative impact on market liquidity. Both, the Commission and the Council have recognised the problem and supported the introduction of a special tax policy derogation for the application of the reverse charge mechanism on emission allowances, gas and electricity transactions. Unfortunately, as of today, not all member states make use of the given reverse charge derogation. The latter constitutes the only safe protection against VAT fraud in the energy markets and can prevent significant tax income losses for national Exchequers. The European Commission should therefore further encourage the member states to promote the safety and integrity of the EU energy wholesale markets by applying the given tax derogation at national level. Additionally, the Commission should proactively propose to change the sunshine clause for the applicability of the reverse-charge derogation for gas, electricity and emission allowances and advocate a permanent solution.
- Should it be implemented as currently proposed by the ten EU member states working under enhanced cooperation, the Financial Transaction Tax (FTT) will lead to a significant decrease in market liquidity in energy trading and will result in a loss / limitation of the price signal for the real economy. This would not only put the efficient functioning of the energy derivative markets into existential danger, but would also take away the price reference for the closely interconnected energy spot markets. In addition to the other downsides of including energy derivatives into the scope of the FTT, such a step would be highly disproportionate vis-à-vis the fairly small gains in additional tax revenues.

3. Investor and consumer protection

No opinion.

4. Proportionality / preserving diversity in the EU financial sector

- As stated in our response to Question 2 on market liquidity, there is a strong risk that the substantial burden from the MiFID II requirements will incentivise companies to either significantly limit or completely stop their trading activities. Many energy trading firms will have to become MiFID-licensed, despite the fact that these firms are not comparable to purely financial entities. Non-financial energy market participants (e.g. utilities) pose no threats to deposits, raise no issue of investor protection and have no access to central bank liquidity. Utilities depend significantly on hedging for commercial risk mitigation, and should not have to fully comply with the numerous financial and organisational requirements of MiFID II / MiFIR. This is especially important as MiFID defines the scope of application for other existing and future legislations (e.g. CRD IV/CRR, EMIR, MAD II/MAR, Benchmark Regulation). Energy market participants use the instrument of energy trading for mitigating their price risk along the value chain (sourcing, production and retail-business). This is a usual and important commercial practice, and constitutes a necessary prerequisite for ensuring stable and reasonable prices for the real economy and final consumers. Applying all provisions under MiFID II to the electricity, gas and emission allowances markets would not only be disproportional to the intended policy objectives of MiFID, but would also contradict the general aim of the further integration of the EU's internal energy market. (Please see our response to Question 2 on market liquidity for our recommendations to the ancillary activity exemption and the position limits regime.) In addition, we do not deem prudential requirements such as minimum own funds requirements, large exposure limits and liquidity requirements (including the Liquidity Coverage Ratio (LCR)) appropriate or warranted for commercial market participants, including those unable to make use of the MiFID II exemption. Such requirements have the potential to drive market participants from, and fundamentally undermine, European commodity derivative markets. A specific framework in CRDIV / CRR should be implemented to limit the licensing requirements for commodity companies.
- Including energy derivatives into the scope of the FTT would be highly disproportionate vis-à-vis fairly small gains in tax revenues and could lead to regulatory arbitrage. Moreover, it will significantly decrease liquidity and lead to a loss / limitation of price signals for the real economy. (See also our response under question 2 on market liquidity.)

B. Unnecessary regulatory burdens;

5. Excessive compliance costs and complexity

- See also our answer to Question 4 on proportionality.
- Utilities depend significantly on hedging for commercial risk mitigation and should thus not have to fully comply with the numerous financial and organisational requirements of MiFID II/MiFIR. This applies in particular to the CRD IV requirements which kick-in as a consequence of a MiFID license. The great number of new

regulatory requirements that are currently being developed and/or implemented does not only lead to a heavy workload for public administrations but also for private firms. This also includes market infrastructure providers, such as exchanges and central counterparties. In reaction, they have to dedicate a significant amount of resources to cope with the additional requirements. Specifically, in the case of the relatively small energy exchanges who are members of Europex, this results in a situation where literally half of a company's resources are spent on establishing the necessary processes and infrastructures to comply with the new rules. This significantly limits their capacity to develop new or extent existing business activities. In the end, this weakens the competitiveness of European exchanges and European central counterparties and indirectly the European economy as a whole.

- A specific framework in CRD IV / CRR should be implemented to limit the licensing requirements and the capital costs for trading for commodity companies.
- The impact of EU financial regulation, compared to what G20 leaders committed to in 2009, is very broad. This is especially true for the commodity sector. All investment firms are treated the same way, while the risks are different in each sector.

6. Reporting and disclosure obligations

- As a general remark, it is important to note that trading venues and investment firms have oftentimes difficulties in obtaining the information to adhere to the reporting requirements applicable to them. These entities must not be held responsible and/or liable, if they do not receive the information, if they only receive the information partially, if they receive wrong information, if they do not receive the information on time or a combination thereof.

- Furthermore, it is not entirely clear what will be the purpose of the data that market participants and trading venues have to provide to EU institutions and/or national competent authorities. Despite the fact that a considerable amount of data has already been sent to ESMA, the Agency has not been able to come up with a comprehensive definition of "EU trading" in the context of the ancillary activity exemption discussion under MiFID II.

7. Contractual documentation

No opinion.

8. Rules outdated due to technological change

- The current rules on portfolio margining under EMIR are very strict. Unless correlations between financial instruments are significant, reliable and resilient under-stress-portfolio-margining is not allowed. These rules, which stem from an outdated clearing model of the 1990s, should be softened in order to encourage the use of portfolio margining.

9. Barriers to entry

As already mentioned in our response to Question 5 on excessive compliance costs and complexity, we would like to highlight again that the high number of new regulatory requirements, particularly under MiFID II, lead to a heavy workload for public administrations and private companies alike. This also includes market infrastructure providers, such as exchanges and central counterparties. In reaction, they have to dedicate a significant amount of resources to cope with the additional requirements. Specifically, in the case of the relatively small energy exchanges who are members of Europex, this results in a situation where literally half of a company's resources are spent on establishing the necessary processes and infrastructures to comply with the new rules. This significantly limits their capacity to develop new or extent existing business activities. In the end, this weakens the competitiveness of European exchanges and European central counterparties and indirectly the European economy as a whole. Hence, it is important that exemptions are wide enough (see our response to Question 2 on market liquidity and to Question 4 on proportionality) to avoid market entry barriers for smaller and/or new parties. This is also important in order to avoid an increased market concentration with less competition.

C. Interactions, inconsistencies and gaps;

10. Links between individual rules and overall cumulative impact

- In order to avoid regulatory arbitrage and preserve diversity and business activity in Europe, EU financial regulation must not lead to a higher regulatory burden than exists in comparable third countries/regions. As mentioned in our answer to Question 5 on excessive compliance costs and complexity, the impact of the revised EU financial services rules compared to what the G20 leaders committed to in 2009, is very broad and reaches beyond the set objectives. The EU needs to prioritise its principle of global equivalence and create a level playing field between EU and non-EU entities.

11. Definitions

- The MiFID II hedging definition should be consistent with the hedging definition under EMIR.
- Annex I C.6 of MiFID II explicitly excludes OTF-traded energy derivatives that must be physically settled from the definition of financial instruments. Europex has repeatedly expressed its great concerns that the type of trading venue must not be used as a basis for determining whether a contract is a financial instrument or not. Given the fact that trading in financial instruments brings along many obligations and potentially higher costs, the present exemption puts Regulated Markets at a massive competitive disadvantage in comparison to OTFs. Moreover, there is indeed a circularity effect when the definition of a financial instrument is dependent on the type of trading venue on which this financial instrument is traded, while the definition of a trading venue is itself based on the financial instruments traded on it. New or revised legislation needs to focus on re-establishing the level playing field between the different types of trading venues.

12. Overlaps, duplications and inconsistencies

- The different timing of the individual reform packages has been a major obstacle for the harmonisation and consistency of the EU's new financial services rules. CRD IV, for instance, had already entered into force, before MiFID II and the revised financial instruments definition was adopted.
- Please see our response to Question 11 on definitions for further details.
- The level of cooperation between ESMA and ACER should be improved.
- EMIR, REMIT and MiFID constitute three different regimes/formats/reporting mechanisms for reporting information of the same kind, namely orders and transactions. Market participants and trading venues must implement three separate reporting environments/processes, one for each legal/regulatory requirement. Moreover, there is double reporting between REMIT and MiFID, EMIR and MiFID, and REMIT and EMIR.
  - Both MiFID and EMIR require transaction reporting for different purposes.
  - REMIT requires orders reporting for financial instruments and transaction reporting is not mandatory. However, ACER has asked for transaction reporting on a voluntary basis, because the reconciliation of orders transmitted under REMIT with transactions reported under REMIT/MiFID is very difficult, if not impossible.
  - The reporting parties involved are quite different in the three environments. This represents a heavy burden for the industry and significantly increases its operational costs. New legislation needs to streamline the reporting requirements as much as possible. (See our answer to the Question on gaps for further details).
- Another important obstacle is the different implementation of financial services rules in individual member states. This applies, e.g., to the lack of harmonisation related to OTFs, MTFs, etc..
- Market parties and other energy market stakeholders need to take strategic decisions about the future of their businesses in response to the new regulatory framework. Utilities, who have so far benefited from a general exemption for commodity trading, would be obliged to obtain a MiFID license as early as in January 2017, provided that their trading activity is not considered ancillary to their main business. Given that the ancillary activity exemption in Article 2 of MiFID II depends significantly on hitherto non-disclosed market data and elements of the threshold calculation methodology that still have to be further defined, utilities are currently unable to start adapting their behaviour to the new framework. Therefore, only 2018 trading data should be taken into consideration when calculating the future thresholds.

13. Gaps

- As previously stated, MiFID II requires the creation a third reporting regime in addition to the ones already in place under EMIR and REMIT. Against this background, it is important to note that the reporting requirements under EMIR and REMIT serve different purposes and produce different datasets than under MiFID II. In EMIR, systemic risks and the overall market safety are the main concerns. In REMIT and MiFID, however, the key objective is to collect market information for monitoring and surveillance purposes. This is to ensure the adequate functioning of European markets, primarily in terms of market transparency and integrity. In our view, as far as transactions, orders and positions reporting are concerned, these different focuses should be addressed only by two reporting regimes:

- One for MiFID II/REMIT, covering orders and transactions, and;
- One for EMIR, covering positions.

The data should be transmitted to only one entity, and efficient communication procedures should be put in place to guarantee an easy and safe access to the data by all authorised entities.

D. Rules giving rise to unintended consequences.

14. Risk

- The current definition of financial instruments in relation to commodity derivatives in MiFID II is too narrow to avoid a shift of liquidity to trading in non-financial instruments. Please see our answer to Question 2 on market liquidity for further details.

15. Procyclicality

No opinion.