

EUROPEX response to the ESMA consultation on
"Guidelines on the application of C6 and C7 of Annex I of MiFID"

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EUROPEX, the association of European energy exchanges, welcomes the present consultation by ESMA as the future "Guidelines on the application of C6 and C7 of Annex I of MiFID" will help harmonise the diverging national regulatory practice of EU regulation in commodities trading. In order to achieve a regulatory level playing field across all EU member states, it is indispensable to comprehensively align the implementation and application of existing and future legislation. This is not only important for the further development of the internal financial market but also to ensure that regulation does not interfere with competition. In this context, we deem it crucial that ESMA strengthens its harmonising role in the future even further and makes full use of its powers as the EU's central securities and markets authority.

Considering that the entry into application of MiFID II is scheduled for January 2017 – in only two years – the establishment of the ESMA guidelines, exclusively referring to MiFID I, is urgently needed in order to remain a useful exercise. As the NCAs will require some additional time to properly assess and implement changes based on the ESMA guidelines, the document would need to be published as soon as possible, meaning in the first half of 2015.

In addition, EUROPEX would like to highlight that ESMA needs to prevent any inconsistencies with regard to the implementation and application of the MiFID II definition of commodity derivatives in advance. Given the technically and legally limited nature of the planned delegated act on the definition of contracts "that must be physically settled", additional guidance from ESMA is likely to be needed. As soon as the Commission will have adopted its RTS on the definition of commodity derivatives under MiFID II in 2015, ESMA should start with the review of the relevant guidelines and adopt them in due time. This will ensure a harmonised application of MiFID II and all other EU legislation linked to the MiFID financial instrument definition.

Please find below our response to the ESMA consultation on "Guidelines on the application of C6 and C7 of Annex I of MiFID":

Q1: Do you agree with ESMA's approach on specifying that C6 includes commodity derivative contracts that "must" be physically settled and contracts that "can" be physically settled?

EUROPEX fully agrees with the assessment by ESMA that "forwards" are indeed to be subsumed by "any other derivatives" in C6. Given that usually off-exchange traded forward contracts are very similar to usually on-exchange traded future contracts and that both are easily substitutable from a commercial point of view, it is only consequent that C6 covers forwards and futures similarly. Hence, both contract types – when traded on a RM or an MTF – should be considered financial instruments, irrespective of how they are called. In addition, this clarification helps avoid regulatory arbitrage.

The general differentiation between contracts that "can" be physically settled" and those that "must" be physically settled seems an obvious distinction; while the latter only constitutes a subset of the first ("must" < "can"). However, it is important to note in this context that almost all contracts in gas and power trading can be considered as "can be physically settled". Yet, the overall market share of contracts that "must" indeed be physically settled is significantly smaller as it is directly linked to the ultimate production and consumption of energy. In the gas market, e.g., churn rates above 20 can be observed, which means that the traded volumes are 20 times higher than the volumes actually delivered to the grid.

Generally, Recital 10 of MiFID II provides a good basis for the further definition of wholesale energy products that "must" be physically settled.

Q2: Do you consider there are any alternatives for or additions to the proposed examples of "physically settled" that ESMA should consider within the definition of C6? If you do, what are these?

EUROPEX considers the proposed examples to be sufficient. However, for the sake of clarification, we would like to point out that physical settlement in gas and power trading is mostly done in contracts that "can be physically settled" while the actual volume of actual physical delivery takes up only a very small share of the overall market volume.

Q3: Do you agree with ESMA's discussion of the relationship between definitions C5, C6 and C7 and that there is no conflict between these definitions? If you do not, please provide reasons to support your response. In particular, ESMA is interested in views regarding whether the proposed boundaries would result in "gaps", into which some instruments would fall and not be covered by any of the definitions of financial instrument. ESMA also seeks views on whether there are any adverse consequences from the fact that some instruments could fall into different definitions depending upon the inherent characteristics of the contract e.g. those with "take or pay" clauses that may be either cash or physically settled.

EUROPEX does not see any inconsistencies in the relationship between the definitions in C5, C6 and C7.

Q4: What further comments do you have on ESMA's proposed guidance on the application of C6?

As rightly stated in the present ESMA consultation paper, there are a number of difficulties with regard to the uniform application of C6 (and C7). The sudden appearance of non-MTF platforms in relation to the entry into force of EMIR, e.g., is one of them. These non-MiFID regulated trading venues have been explicitly created to avoid being caught under C6. Given that some NCAs have confirmed them not to be MTFs and hence to remain outside the scope of financial regulation, the current C6 MiFID financial instrument definition does not apply to the products traded on them. Hence, all contracts concluded on non-MTFs do neither constitute Exchange Traded Derivates (ETDs) nor OTC traded derivatives in relation to EMIR. These non-MTFs base their *raison d'être* on the sole argument that they would act discretionarily. In this context, however, it is very difficult to draw the line between discretionary and non-discretionary practices. The electronic trading technology behind the trading screens works *de facto* very similarly in both cases and execution happens without any real intervention for almost all trades. In reaction to the introduction of EMIR, there has been a very significant shift of liquidity away from "traditional MTFs" to non-MTFs. Today, interestingly, almost no OTC derivatives are concluded in the energy markets. Most of the contracts are either ETDs concluded at exchanges or non-financial instruments traded on non-MTFs.

Against this background, it is important to note that MiFID II is very likely to widen this shift and to diminish the share of financial instruments in energy trading even further. Given that from 2017 onwards gas and power derivatives that are traded on an OTF and "that must be physically settled" do not fall under C6, EUROPEX is convinced that more trading will move outside the reach of financial regulation, should the related delegated act on the definition of physical settlement be too large.

Q5: Do you have any comments on ESMA's proposed guidance on the specification of C7?

No.