



# **The Impact of Financial Services Regulation on European Wholesale Energy Markets**

A Post-MiFID II Analysis

## About Europex



Established in 2002, Europex is a not-for-profit organisation representing the interests of exchange-based wholesale electricity, gas and environmental markets in relation to the European regulatory framework for wholesale energy trading. The objectives of the Association include the promotion of the role of energy exchanges as a way of increasing competition in the European internal energy market, supporting the liberalisation of the different European electricity and gas systems and fostering co-operation between European energy exchanges.

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### Impressum

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## Executive summary

In a competitive and liberalised energy market, different market timeframes serve different needs. Market participants use short-term markets to buy or sell power and gas and to optimise their positions, while forward (derivatives) markets are used to hedge positions and manage risks such as price volatility. Both short-term and forward wholesale markets need to function well in order to allow efficient risk management and ensure end consumers have access to secure, sustainable and competitive energy supplies.

The European energy sector is currently undergoing a profound transformation to deliver on decarbonisation goals with the objective to reach a climate-neutral economy by 2050. Short-term energy markets keep innovating to support the increasing penetration of renewable and decentralised resources – while facing challenges such as production intermittency and price volatility. Market participants across many real economy sectors need access to efficient, transparent and liquid forward markets to be able to hedge and efficiently manage their risks in a rapidly evolving physical energy commodity market. The role these spot and forward markets play will become increasingly important as decarbonisation efforts progress.

Following the introduction of MiFID II / MiFIR on 3 January 2018, the great majority of gas and electricity derivative contracts as well as all EU ETS emission allowances were newly classified as financial instruments – along with all other commodity derivatives. New rules applied to market infrastructure providers, such as energy exchanges, and market participants and led to significant changes throughout the energy trading community.

Against this background, Europex asked Norton Rose Fulbright, an international law firm, to critically analyse the relationship between European financial services regulation and energy markets. This report thus examines the impact of MiFID II and MiFIR requirements, as well as provisions in EMIR, MAR and REMIT, in terms of both the achievement of the policy objectives and the practical implications for energy markets. Given that European energy markets are an integral part of the wider global energy markets, the report also looks at how major international jurisdictions that host energy trading venues, such as the United States, Singapore and Switzerland, are dealing with the regulation of energy wholesale trading.

Drawing on direct feedback from a range of stakeholders, the report highlights that several aspects of MiFID II / MiFIR for energy commodity derivatives are ill-calibrated, and risk either hampering growth or pushing transactions onto less transparent over-the-counter (OTC) and bilateral markets. The position limit regime in particular was found to be restricting growth in nascent euro-denominated contracts as well as failing to ensure a level playing field between exchanges offering contracts with the same physical underlying. Other topics identified as needing improvement include the hedging exemption for the position limit regime, pre-trade transparency requirements under MiFIR and the requirements for financial entities participating in energy markets.

The comparison of the European regulatory landscape with other international jurisdictions demonstrates that there is precedent for both applying position limits to a limited set of 'critical' commodity derivative contracts and/or delegating the task of determining them to exchanges, as it is the case for the US or Singapore.

The below guiding principles and recommendations (the full recommendations are provided in Section 5) identify improvements that can be addressed as the framework is reviewed. The report argues that European financial services and energy regulation need to be sufficiently aligned to ensure that forward markets can serve their purpose, whilst contributing to the transparency and stability of financial markets. Strong and clear price signals are needed in an ever more complex energy system, to allow for proper price risk management, to enable the energy transition and to meet the EU's and global climate targets.

Finally, it is important to mention that much of this report was prepared before the COVID-19 pandemic. Without prejudging the implications of this pandemic on the European energy sector and the wider economy, we believe it is even more critical now that the financial services framework appropriately addresses the unique characteristics of the physical energy and energy derivatives markets and their participants. We hope that this report will contribute to an informed and fruitful debate between European policymakers, regulators and market stakeholders.

### **Principle 1: Securing competitiveness of European energy markets**

#### **Recommendations**

1. Ensure that the position limits regime for commodity derivative markets does not adversely affect the development of the European energy markets.
2. Provide a regulatory framework that does not encourage market participants to shift their power and gas derivative business to third-country jurisdictions and/or OTC.
3. Provide a consistent, predictable and robust regulatory framework that fosters innovation in the energy markets.

### **Principle 2: Reflecting the specific characteristics of the European energy markets**

#### **Recommendations**

4. Ensure that the rules governing the pre-trade transparency requirements for the energy derivatives markets are appropriately calibrated for in-scope gas and electricity products.
5. Adjust the commodity derivatives position limits regime in a manner that is proportionate to the nature and risk profile of the energy markets and their participants, including by taking due consideration of the corresponding rules set out by the REMIT and MAR regimes.
6. Develop a regulatory framework that allows European energy markets to continue providing a much valued interplay between physical energy and energy derivatives markets.

### Principle 3: Ensuring proportionality vis-à-vis physical market participants

#### Recommendations

7. Ensure that compliance with regulation does not create unnecessary barriers to entry for smaller and/or new physical market participants.
8. Maintain a simple and workable ancillary activity exemption that allows physical market participants with limited activities in financial markets to use simplified rules.
9. Recognise the importance of pre-arranged transactions for energy markets, in a proportionately calibrated and harmonised pre-trade transparency regime applicable to such transactions.
10. Ensure that regulatory requirements applicable to financial entities do not result in adversely affecting their client business, including the provision of access to derivatives trading and clearing services.

### Principle 4: Recognising the importance of financial entities for the energy derivative markets

#### Recommendations

11. Introduce permission for financial entities to use the hedging exemption from the position limits regime when trading on behalf of non-financial entities and/or providing liquidity for trading venues listing energy derivatives contracts.
12. Adjust the pre-trade transparency regime for commodity derivatives in a manner that allows financial entities to use the hedging exemption when trading on behalf of non-financial, physical market participants.
13. Take due consideration of the overall impact that financial services regulation, including prudential requirements, have on European financial entities that are participants in energy markets.

### Principle 5: Simplifying and streamlining the regulatory framework

#### Recommendations

14. Limit the complexity of regulatory reporting requirements, including by identifying and eliminating overlapping data reporting fields.
15. Conduct a comprehensive review of regulatory reporting requirements leading to a comprehensive approach to regulatory change.



## Introduction

### Energy market liberalisation: achievements so far

The design of the energy markets we see in Europe today stems from fundamental changes to the way energy was supplied following the introduction of liberalisation rules. Successive liberalisation packages separated production, distribution and trading monopolies and resulted in a competitive market for energy trading. Open and competitive access to power and gas is an important pillar of the Internal Energy Market, as are the principles of consumer protection, non-discriminatory access to the grid and good levels of inter-connection between Member States.

Energy exchanges have evolved as a result of this process and are now an important component of the energy market infrastructure because they bring together buyers and sellers of energy and determine competitive and transparent prices for energy products. This process of matching demand and supply in an efficient way creates significant welfare gains for consumers and other end users, while these prices also serve as a transparent reference for many other markets and sectors.

Exchanges have also helped to drive innovation in the market by creating products that enable buyers and sellers to take and make delivery in different timeframes and derivative products in the forward market that can be used by producers and industrial consumers to mitigate the risk of changes in price and other variables over those periods. The markets have also become more diverse in the types of products traded, who buys and sells them, how they do so and why.

### The next challenge: how can energy markets help to achieve the 2050 net zero target?

Well-functioning energy markets are vital to support efficient decarbonisation efforts. As the energy system evolves, energy exchanges will continue to play a key role in the energy transition on the way to full climate-neutrality by 2050. Indeed, efficient, liquid and transparent power and gas markets will help to ensure that the energy transition is delivered at the lowest possible cost - an important factor in making net zero socially and economically feasible. Integrated energy markets contribute to decarbonisation efforts:

- By providing innovative short and long-term products to support the increasing penetration of renewable and decentralised resources, while maintaining system balance;
- By ensuring market participants across many real economy sectors can hedge risks emerging from the changing energy system and efficiently manage risks such as price volatility.
- By providing transparent price signals which incentivise the deployment of the most efficient technologies, as well as stimulate longer term investments in carbon reducing technologies;
- By ensuring that consumers, prosumers, as well as all types of decentralised generation and storage benefit from links to fully-integrated and liquid organised energy markets.

## Impact of regulation: regulatory challenges facing energy exchanges

Liberalisation brought increased regulation to many aspects of the energy sector, much of which is still required to maintain the separation of vertical silos which might otherwise be the natural result of a grid-based system. The energy system remains a highly regulated sector with generation, supply and trading being subject to close oversight by National Regulatory Authorities (NRAs) and, at European level, by the Agency for the Cooperation of Energy Regulators (ACER) and operating in accordance with harmonised rules including Network Codes and Guidelines.

In addition to physical energy market regulation, energy exchanges that offer trading in financial instruments are also subject to supervision by National Competent Authorities (NCAs) and, at European level, by the European Securities and Markets Authority (ESMA). The 2008 financial crisis triggered a significant amount of new financial services legislation driven by the G20 Pittsburgh commitments that were agreed upon internationally and implemented locally. Some of the reforms were directed at over-the-counter (OTC) derivatives generally while others were targeted specifically to commodities and commodity derivatives. This has impacted not only operators of exchanges and other trading venues but also those that trade on them for hedging or liquidity provision reasons, brokers on these and related OTC markets, and those involved in risk management and back office. While much of this legislation supports the good practices that the energy exchanges had already adopted voluntarily, it is important to ensure that each detailed requirement is appropriately tailored to the characteristics of the energy markets so as not to undermine either its own objectives or those of liberalisation and decarbonisation.

## Need for a global perspective

Finally, although this report focuses on European energy markets, these markets need to be understood in the wider context. Europe relies on international energy markets to meet its energy demand which means its markets are also driven by external factors such as the large scale development of shale oil and gas resources as well as the emergence of a global Liquefied Natural Gas market. Equally, energy exchanges outside the EU compete for business with EU exchanges and therefore it is relevant to understand how regulatory requirements impact the experience of users both within and outside Europe.

## Purpose of the report

The aim of this report is to assess the impact of European financial services regulation on energy commodity trading, to identify where its objectives have been met and determine where further improvements could be made. The ultimate aim is to ensure that European financial services and energy regulation are sufficiently aligned to enable European energy exchanges to continue to provide affordable energy prices for all, keep a high level of security of supply and contribute to the successful and cost-efficient implementation of the decarbonisation of the energy system while remaining competitive at a global scale.

The recommendations formulated as a result of this assessment are mainly addressed to the European Commission, European legislators as well as European and national regulators. As the targeted review of certain European financial services legislation evolves, these recommendations are intended to feed into the discussions and help decision-makers to better understand the specific characteristics of the European energy markets. We believe that such informed and evidence-based debate will result in a more effective reflection of the role and characteristics of the European energy markets and their participants, both financial and non-financial, in existing and new financial services legislation.

## Outline of the report

Following this introduction, the report is organised as follows:

**Section 1: European energy markets – an overview** – This section is intended to provide an overview of what is meant by energy wholesale markets, what challenges they have undertaken, what they face going forward, the different ways in which they operate and how they interact with one another.

**Section 2: Energy trading in the framework of EU financial services regulation** – This section seeks to provide a high level overview of the main financial services regulatory requirements that are applicable to energy wholesale markets and to explain the objectives underpinning the regulation.

**Section 3: Regulatory impact in practice** – This section provides a view on what financial services regulation means in practice for the energy wholesale markets and their participants.

**Section 4: Comparison of the European regulatory landscape with other international jurisdictions** – This section considers how the EU financial services legislation applicable to energy exchanges compares to that of other key jurisdictions and any lessons that can be learned from them.

**Section 5: Key policy recommendations** – This section sets out Europex proposal for the changes that should be considered to financial services regulation in relation to energy exchanges, based upon five guiding principles: (1) securing competitiveness of European energy markets, (2) reflecting the specific characteristics of the European energy markets, (3) ensuring proportionality vis-à-vis physical market participants, (4) recognising the importance of financial entities for the energy derivative markets and (5) simplifying and streamlining the regulatory framework.

## Brexit

The UK formally left the EU on 31 January 2020 but at the time of writing the transitional period foreseen by Article 126 of the Withdrawal Agreement is in place and European law continues to apply to the UK. References in this report to the EU therefore include the UK. The UK leaving the EU creates an added layer of complexity to the wholesale energy markets, particularly to those markets that are subject to EU financial services legislation. The UK's departure also triggers a new chapter in EU-UK relations and negotiations about the future shape of such arrangements are underway. From a financial services regulation perspective, such arrangements are likely to be based on an equivalence mechanism. Notwithstanding, with both parties' underlying "unilateral" character of future equivalence assessments and maintaining regulatory sovereignty, the UK becoming a third-country jurisdiction will add yet another dimension to the EU network of international relations for physical energy and energy derivatives markets regulation.





# 1. European energy markets

An overview

This report is about European energy wholesale markets. This first section therefore seeks to explain what they are and the relevant aspects of how they operate. Although traded energy commodities include electricity, gas, coal, oil, biofuel and others, we focus in this report on electricity, pipeline natural gas and liquefied natural gas (LNG).

In this first section, we use terminology that is common in energy markets to explain the key concepts. The precise definitions used in financial services legislation are explained at the end of this section.

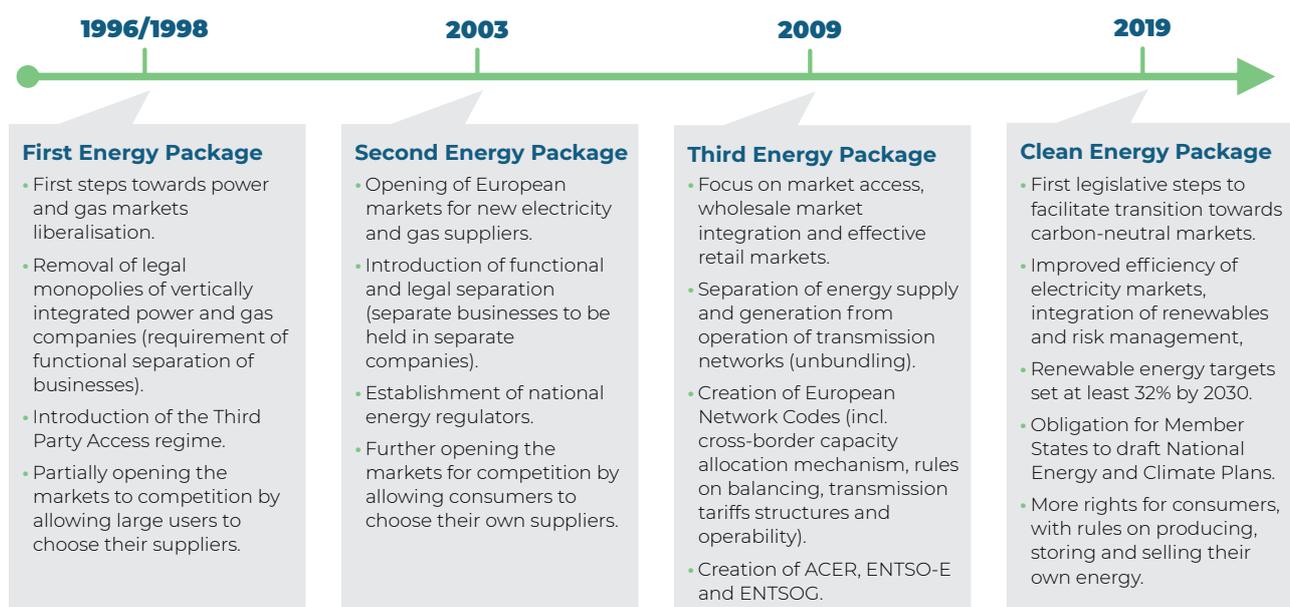
## 1.1. Energy market fundamentals

Over the last 25 or so years, the European Commission has sought to liberalise European energy markets through a series of ambitious initiatives, some of which still continue today. It has required national markets to become more competitive and has worked to encourage more cross-border activity with a view to creating a single European market in energy, the Internal Energy Market. There have been several objectives of such efforts but the most important relate to the introduc-

tion of fair competition between generators and between suppliers, equal access to the electricity and gas grid and ensuring customers have a genuine choice as to where to buy their power and gas at a fair price.

Liberalisation has been achieved through a series of key packages of European legislation which are summarised in Figure 1.

**Figure 1: Energy markets liberalisation: snapshot**



Prior to this process, there was vertical integration of generation, transmission, distribution and retail supply of gas and power within most Member States of the EU. There was no need for energy markets since all these processes could be undertaken within a single organisation or group, provided a buyer had a relationship with such an orga-

nisation, and would not need to go elsewhere. In fact, this meant that customers had no choice of supplier regardless of their size and that cross-border trade was controlled by companies that could set cross-border tariffs and allocate cross-border transfer capacity.

### Role of energy exchanges in a liberalised energy market

Energy markets liberalisation introduced competition among market players by reshaping a traditionally conservative and vertically integrated sector of wholesale energy production and trading. One of the features of this structural evolution was the development of new market players, including modern energy exchanges. In a liberalised energy market, exchanges play a fundamental role: as well as bringing together supply and demand from different types of market participants, they allow market participants to anonymously display their true willingness to pay for their production costs in the process. Matching these bids and offers helps to create a fair and efficient price which is available to all participants, as well as communicated externally, so there is a level playing field within the market, which can also be used outside it. During the liberalisation of the energy sector in the EU, and worldwide, electricity and gas trading dramatically increased in many countries and Europe saw a wave of new energy exchanges and over-the-counter (OTC) markets emerging.

Today, the energy markets look very different. Figure 2 shows the effect of liberalisation on market structure. Unsurprisingly, however, such a complex reform has had more impact on some areas than others. For example, it is not clear that the energy packages have achieved anything beyond modest gains in terms of pricing, not least because a number of different initiatives were developed in parallel. One of these developments was the progression of the renewables sector, which has become a key part of further objectives as explained below, but some of the pricing gains have been used to support and effectively subsidise.<sup>1</sup> In wholesale electricity markets, prices across EU Member States continue to vary significantly, and certain individual national markets continue to experience price swings – in both upward and downward directions.<sup>2</sup> Overall, however, average European wholesale market prices have decreased over the long-term.<sup>3</sup>

In any event, the initiatives have been successful in achieving fundamental changes to the structure of the energy markets which are considerably more unbundled and liberalised today. Power and gas have been opened up to competition between utilities and new competitors. Open and non-discriminatory access to transmission and distribution network infrastructure has been a cornerstone of market liberalisation. Retailers, wholesalers, traders and producers can buy and sell power and gas, market their products and secure themselves against risks. Consumers can now choose between competing suppliers and benefit from better offers, facilitated by regulations that mandate a transparent and simple process for switching suppliers. Today, there are several hundred companies involved in the energy market and more than 10,000 transactions every day.<sup>4</sup>

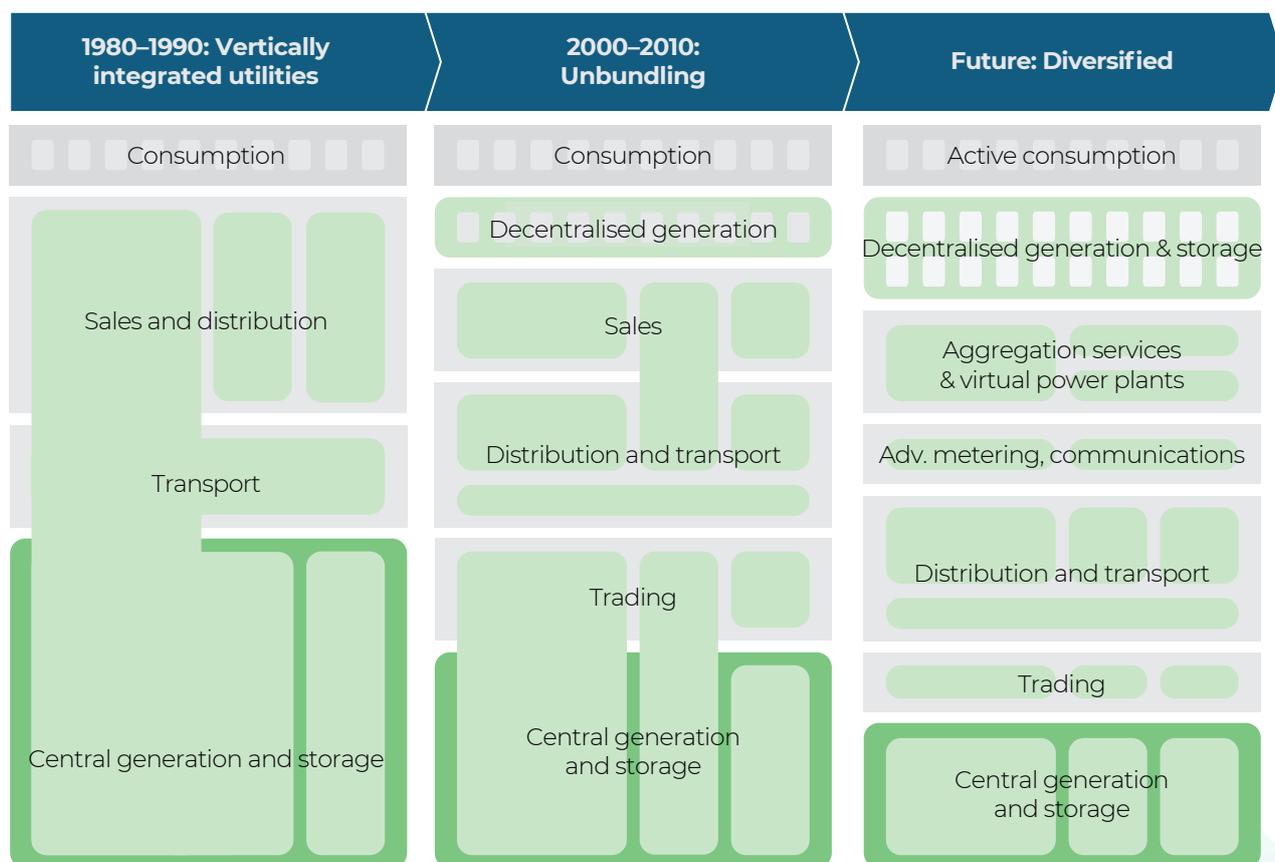
1 European Commission, Quarterly Report on European Electricity Markets, Market Observatory for Energy, Volume 13 (issue 3, third quarter of 2019) ([link](#)). According to the European Commission's statistics for Q3 2019, the evolution of the electricity mix across the EU Member States shows "the declining role of coal and lignite which were increasingly squeezed out by gas and renewables". In terms of percentage, when comparing Q3 2019 to the same quarter the previous year, the share of fossil fuels decreased from 42% to 39%, while the share of renewables rose from 31% to 33%.

2 Ibid.

3 Commission Staff Working Document: Impact Assessment of the Market Design Initiative, 30.11.2016, (SWD(2016) 410 final) ([link](#)).

4 Source: European Commission ([link](#)).

**Figure 2: Effect of liberalisation on market structure**



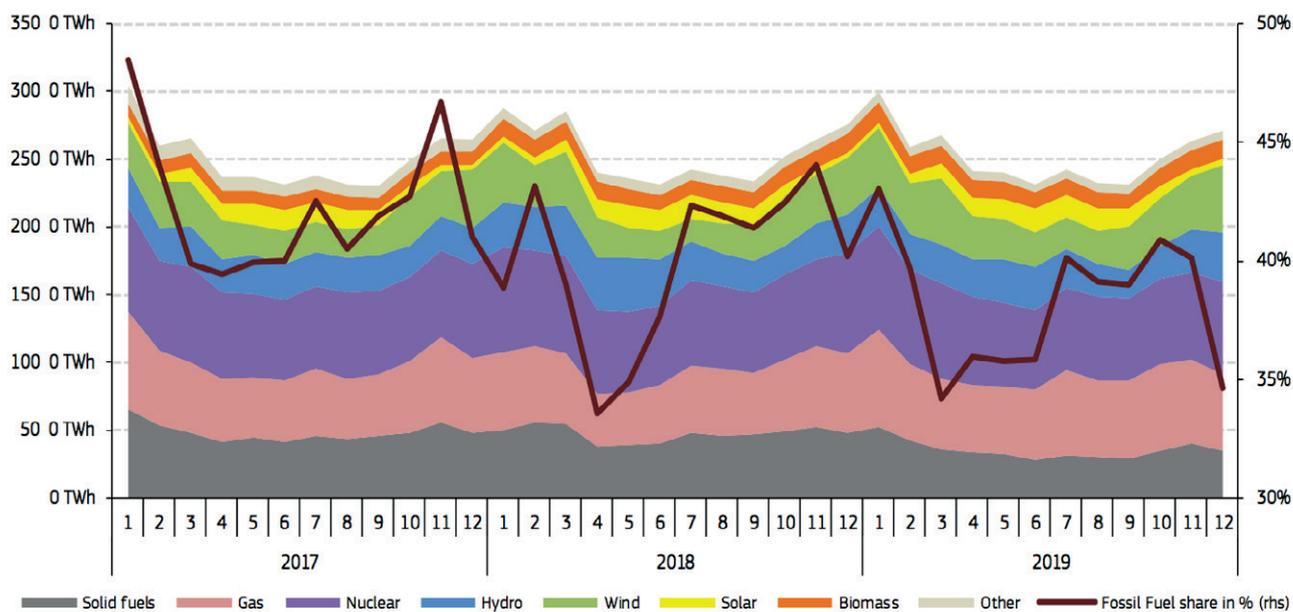
## 1.2. Energy trading as a key enabler of decarbonisation

The decarbonisation agenda is having a significant effect on the power and gas industries. Legislative targets have increased the requirement for energy generation to come from renewable sources such as solar, wind and hydropower. According to Eurostat, renewable energy produced in the EU increased by two-thirds (64%) over the 2007 - 2017 period, which is equivalent to an average increase of 5.1% per year.<sup>5</sup>

Figure 3 shows renewables playing a significant role in the electricity generation mix, which is expected to grow in importance as fossil fuel shares in the generation mix drop.

<sup>5</sup> Eurostat: Renewable energy statistics (data extracted in January 2020) ([link](#)).

**Figure 3: Monthly electricity generation mix in the EU 28 (2017-2019)<sup>6</sup>**



This development of renewable energy has been heavily subsidised by national governments. In recent years there has been a consensus among policy makers that renewables growth should gradually become exposed to real price and volume risks as well as less dependent on subsidies. However, renewable generation is volatile and work will be needed to balance supply and demand and ensure they contribute to system stability. Energy markets play an important role here because they are platforms for efficiently exchanging and balancing supply and demand for power between increasingly decentralised producers and consumers.

### Achieving climate-neutrality and the European Green Deal

Development in the European renewable energy sector has been largely driven by policy objectives.

The EU's ambitions to reduce greenhouse gas emissions and increase the share of renewable energy sources have scaled up over time.<sup>7</sup> The new Commission's flagship initiative of the European Green Deal, outlined on 11 December 2019, sets out ambitious targets for "how to make Europe the first climate-neutral continent by 2050."<sup>8</sup> The creation of the European Green Deal took a step forward with the publication by the European Commission in March 2020 of the proposal for a regulation establishing the framework for achieving climate neutrality (the "European Climate Law"). Criticised by some as not sufficiently ambitious and by others as overly ambitious, the proposed regulation is yet to undergo full scrutiny by the European Parliament and the Council, with substantive, more ambitious amendments already being introduced by the rapporteur. Without anticipating the final outcome of those deliberations, it is clear from the outset that this pledged tran-

<sup>6</sup> Source: ENTSO-E, Eurostat, DG ENER. Fossil fuel share calculation covers coal, lignite, gas and oil ([link](#)).

<sup>7</sup> European Commission: 2030 climate and energy framework ([link](#)).

<sup>8</sup> Communication COM/2019/640 final 'The European Green Deal' ([link](#))

sition to a European climate-neutral economy by 2050 will have the energy sector in the forefront of the change.

In line with those strategies and the 2050 climate neutrality objective, many energy markets are developing or amending products that support the development of renewables, taking into account their less steady supply. Coupled day-ahead and intraday electricity markets are continually innovating to support the integration of renewables and decentralised resources as well as value flexibility, for example, by offering trading intervals which are shorter and closer to real-time as well as smaller product granularity. For example, contracts that can settle within minutes have been developed to hedge volatility risk from the marketing of wind energy and short-term price peaks in the intraday market. Exchanges are also pioneering the development of local flexibility markets to allow further trading of flexibility and value decentralised resources as well as demand-side response.

Energy derivatives markets play a crucial role in enabling market participants to hedge against risks that this changing environment creates. Market participants across many real economy sectors need to access efficient, transparent and liquid forward markets to be able to hedge and efficiently manage risks such as price volatility and counterparty risk. In addition, the price signals of these forward markets are crucial to stimulate investments and thereby drive decarbonisation efforts. The role forward markets play will become increasingly important as decarbonisation efforts progress. Indeed, both spot and forward markets need to be functioning well to provide clear price signals, enable efficient risk management and provide the necessary tools to support decarbonisation.

Energy markets are also supporting innovation in other areas – for example, the provision of long-dated financial derivatives as well as future energy products with physical delivery facilitate the development of Power Purchase Agreements (PPA).

### What is a Power Purchase Agreement?

A PPA is a long-term, bilateral, contract between one party generating and selling electricity and another party purchasing it. These contracts enable businesses to source electricity from generators at an agreed price, while giving producers a reliable, guaranteed buyer at a stable price. When the electricity comes from a renewable energy power plant, it may be necessary to have a PPA in place to secure financing from a bank for the project. These renewable energy PPAs are often fixed for long periods, up to 15 years, to ensure revenue security for the developer. Some of the energy markets have developed longer term futures for those clients that want to hedge their risk under such PPAs. They also provide more certainty in pricing by creating a more secure price and, where the contracts are cleared, Central Counterparties ensure that the parties do not take credit risk on one another.

## 1.3. Specific characteristics of power and gas markets

The secure and sustainable supply of electricity and gas, at competitive prices, to both industrial and retail consumers is crucial for the development and growth of the European economy. Every European citizen depends on affordable access to energy to be able to live and work, and this is one of the reasons why these markets are so highly regulated compared to other commodities.

Ensuring undisturbed access to gas and power for all consumers is therefore high on the agendas of decision-makers across the EU. Well-functioning energy markets are one of the necessary conditions to achieve this.

While electricity and gas are sub-asset classes of a broader family of commodities, they do have

some characteristics that make them unique. In addition to their critical importance to the day-to-day functioning of European businesses and households, their special characteristics stem from their physical attributes. With the exception of LNG, both natural gas and electricity are grid-bound commodities, which mean they are particularly affected by operational security constraints and physical limits of their network infrastructure. Electricity in particular is characterised by very limited and costly storage capacity; consequently, the requirement to continuously balance electricity generation and demand, which impacts on trading patterns in the power markets, is also a defining attribute.

With these characteristics in mind, electricity and gas traded products tend to be described by reference to a series of dimensions. The first is the time between contract formation and maturity or to the point of delivery (time to maturity) that can be anywhere from near-real time to many years in the future. The second is the method of settlement, which could either be by physical delivery of the underlying energy commodity, or by means of a financial payment, meaning cash settlement. The third is the means of trading, which could be through an organised marketplace such as an exchange, bilateral over-the-counter (OTC) trades that take place off-exchange or even direct bilateral contracts traded outside the regulated market. Figure 4 shows the different use cases of spot and forward/futures markets.

**Figure 4: Main elements of energy markets: spot, forward, and futures markets**

	Spot markets	Forward/futures markets
<b>Products traded</b>	Immediate or prompt settlement	Delivery in the future
	<ul style="list-style-type: none"> <li>Commodities traded spot, i.e. settlement within 2 trading days</li> <li>Power and gas are delivered physically</li> </ul>	<ul style="list-style-type: none"> <li>Contracts with a future physical delivery</li> <li>Cash settled derivatives to secure underlying prices at a future point in time</li> </ul>
<b>Main use case</b>	Buy or sell physical quantities	Manage risks and secure prices
	<ul style="list-style-type: none"> <li>Balance production, sales, supply and demand</li> <li>Optimise transmission capacity</li> </ul>	<ul style="list-style-type: none"> <li>Buy or sell a commodity in advance</li> <li>Secure against price changes and high spot market volatility</li> </ul>

**Short-term optimisation and benchmark for futures or forward markets**

**Hedge against risks and secure prices**

Two specific dimensions - time to maturity and method of settlement – are discussed below. The third dimension is discussed later: i.e. the need for an OTC market to reflect the real economy rea-

sons for buying and selling power and gas and the consequent need for tailored contracts, running alongside the standardised contracts traded on energy exchanges.

## Time to maturity: from “real time” to years ahead

Most gas and electricity transactions involve delivery at some point in the future but, unlike other types of commodity, that future can range from the very near term (almost real time) to many years ahead as set out below:

- Long-term contracts: up to 20 years or more;
- On the forward and future markets: weeks to years in advance;
- On the day-ahead market: the following day;
- On the intraday market: delivery within a specified time period the same day (for instance, an hour or a quarter of an hour); or
- On the balancing market: near real-time balancing of supply and demand.

It is important to note that the time to maturity dimension for energy contracts has been largely influenced by developments in the broader energy sector. For example, the long-term contracts were developed by energy exchanges in response to demand by institutional investors, seeking to hedge their risks stemming from investments in renewable energy. Similarly, the need for the intraday and the balancing market was prompted by, among other factors, volatility linked with renewable energy generation and unstable supply. Figure 5 below explains the reasons each of these timeframes may be used and summarises the role that certain market participants play in the value chain.

**Figure 5: The value chain of power and gas markets. Simplified illustration**

	Futures and forwards	Day-ahead auction	Intraday	Balancing
Time frame	<ul style="list-style-type: none"> <li>• Up to several years ahead</li> </ul>	<ul style="list-style-type: none"> <li>• Day before delivery</li> </ul>	<ul style="list-style-type: none"> <li>• Last hours before delivery</li> </ul>	<ul style="list-style-type: none"> <li>• Last minutes before delivery</li> </ul>
Main use case	<ul style="list-style-type: none"> <li>• Buy and sell in advance to secure business against price fluctuations</li> </ul>	<ul style="list-style-type: none"> <li>• Optimise and balance portfolio</li> <li>• Nominate volumes to be fed into the grid</li> </ul>	<ul style="list-style-type: none"> <li>• Adjust for short-term changes</li> </ul>	<ul style="list-style-type: none"> <li>• Deliver committed volumes</li> <li>• Balance the grid to match supply and demand</li> </ul>
Exchanges	<ul style="list-style-type: none"> <li>• Match bids and offers and determine prices for standard products</li> <li>• Provide clearing service</li> <li>• Support transparency obligations</li> </ul>	<ul style="list-style-type: none"> <li>• Manage auctions and cross-border price coupling for cross-border capacity allocation, and determine prices</li> <li>• Manage nomination of volumes towards the Transmission System Operator</li> </ul>	<ul style="list-style-type: none"> <li>• Match bids and offers and provide cross-border capacity allocation, and determine price</li> <li>• Manage changed nominations</li> </ul>	<ul style="list-style-type: none"> <li>• Partly provide balancing services to TSOs</li> </ul>

	Futures and forwards	Day-ahead auction	Intraday	Balancing
Brokers	<ul style="list-style-type: none"> <li>Bring counterparties together and offer expert insight</li> <li>Connect parties to clearing houses where transaction is cleared.</li> </ul>			
Directly between two parties	<ul style="list-style-type: none"> <li>Bilateral contracts traded outside the regulated market.</li> </ul>			
TSOs	<ul style="list-style-type: none"> <li>TSOs manage shipping licenses (gas)</li> </ul>	<ul style="list-style-type: none"> <li>Determine available cross-border capacities</li> <li>Procure balancing capacities (e.g., up to a week before delivery)</li> </ul>	<ul style="list-style-type: none"> <li>Determine intraday cross-border capacities</li> </ul>	<ul style="list-style-type: none"> <li>Dispatch required balancing capacities</li> <li>Determine and invoice imbalances (after delivery)</li> </ul>

### Spot, futures, forward - what do these terms mean?

#### Spot = immediate settlement

In commodity markets, spot transactions refer to transactions that result in delivery upon execution. In wholesale energy markets specifically, spot markets include day ahead auctions and intraday markets, where hourly contracts are traded to correct imbalances that market participants may have after their day-ahead trades. They are used on a daily basis by market participants to adjust their positions. Particularly in electricity markets, the need to balance the supply (generation) and demand (consumption) is constant.

#### Futures and forwards = settlement sometime in the future

Conversely, futures and forwards contracts are used by energy market participants to buy or sell a specific volume of gas or electricity, at a specific price, for settlement on a specific date in the future. There is no official distinction between the two terms but “forward” is generally used to describe a contract that is entered into between two parties who have agreed a set of terms between themselves, whereas “future” usually refers to a standardised contract traded on an exchange. In each case, they are important tools used by market participants, among other purposes, to hedge against price and a variety of other risks stemming from their day-to-day commercial operations. The ability to negotiate a forward allows the market participant to hedge risks that are more specific to its circumstances in a tailored way, whereas futures can be used to hedge more common risks in a potentially more liquid marketplace. This hedging mechanism is critical for both large, industrial energy consumers, as well as for smaller, independent retailers.

## Method of settlement: cash vs physical settlement

As with other commodity contracts, transactions in power and gas can either be physically or cash settled. Physical settlement means that the seller delivers and the buyer takes delivery of the power or gas. Given the nature of power and gas, physical delivery includes delivery by way of making a notification to an energy network such as a notification under the Network Code or the Balancing and Settlement Code.

Alternatively, cash settlement means that the parties settle their obligations by payment of a single cash amount that reflects the difference between, for example, the spot price and the fu-

tures price. As such, there is no physical delivery of the underlying commodity. Some contracts are designed for cash settlement only, while others intend physical settlement but provide a cash settlement option or possibility that is triggered in certain circumstances to allow flexibility.

Cash settlement does not automatically imply speculation. It can be used by an energy producer to mitigate the risk that the market price has fallen by the time it is ready to sell. It also enables market participants that do not want or do not have the means to make or take physical delivery, such as banks and brokers, to intermediate and add liquidity to the markets.

## 1.4. How energy is traded

To use either spot transactions or forwards and futures to achieve their objectives, participants need someone else to buy from or sell to. Counterparties can be found either bilaterally, where two parties approach one another and negotiate their own OTC transaction, or through an organised marketplace which is designed to bring together multiple potential buyers and sellers. There are advantages and disadvantages to each type of trading and some blurring of the traditional distinctions between them.

OTC trading allows the parties to agree to whatever terms they want to govern their transaction. Most energy trading started off as OTC, but as transactions became more frequent, parties began to try to standardise their contracts by using the same terms on multiple transactions.

There are now a number of industry standard framework agreements<sup>9</sup> which many parties use as the basis for their contracts, but the key economic terms such as volume, price and term of any transaction are negotiated and documented to create bespoke arrangements.

Once enough parties can agree to the same economic terms of a contract, it is possible to trade it on a market. In fact, standardisation of contracts is necessary for organised markets to ensure that participants are bidding and offering to buy and sell the same contract, as well as to facilitate settlement and any clearing.

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<sup>9</sup> Contracts include the GTMA introduced by FIA for electricity forwards, the EFET General Agreement Concerning the Delivery and Acceptance of Electricity, and the EFET General Agreement Concerning the Delivery and Acceptance of Gas, each produced by EFET

## What is clearing?

Clearing is the process of guaranteeing financial market transactions between the execution of the transaction and its settlement or the actual fulfilment of the obligations. Both OTC derivatives and those traded on markets can be cleared by a central counterparty (CCP), i.e. a regulated entity that takes on counterparty risk between parties to a transaction. However, while derivatives traded on regulated markets are required to be cleared through a CCP, derivatives that are traded OTC do not face such obligation.

The CCP becomes the buyer to the seller and the seller to the buyer, thereby enabling both parties to transfer their credit risk from one another to the CCP. Clearing involves a number of steps, including establishing positions, calculating net obligations, and ensuring that adequate resources are available to secure the exposures arising from those positions. Beyond the risk management benefits, central clearing also reduces the obligations between counterparties by offsetting different positions in a process called netting. Many energy market participants use a clearing member (which participates in a CCP) to act as the interface between them and the CCP. The CCP is highly regulated and subject to strict requirements designed to manage the risk of one of its members defaulting.

One of the key advantages to using an energy market is the potential liquidity that might be found there. If a seller needs to sell, whether to manage its stock or to hedge its risk, it may stand more chance of finding a willing buyer in a market. In financial markets, in particular, participants who provide liquidity by offering to enter into transactions in exchange for a small margin, so-called market makers, play a crucial role. Energy markets are efficient ways of enabling different types of participants with different purposes to come together. Energy markets may also enable participants to secure a more competitive price because the cost of a transaction is driven by the 'bid-offer spread' or the difference between prices for buying and selling. The relationship between the bid-offer spread and liquidity is inversely proportional: increased liquidity means a decreasing bid-offer spread. Market participants tend to follow liquidity and concentrate their trading activity on liquid markets where they find reliable and cheap access to the market, thus increasing liquidity in already liquid markets. Conversely, as will be discussed later in this report, the same behaviour makes it more challenging for new and illiquid markets to develop. Unless energy markets can attract and retain sufficient liquidity, market participants have less incentive to use them and trading remains bilateral.

Markets that facilitate trading in energy derivatives are required to be regulated as trading venues and are subject to supervision by a financial services regulator in the EU. They are subject to a wide range of requirements designed to protect both the markets and those who use them. For example, trading venues must operate on a non-discriminatory basis so that all appropriate participants can access their liquidity. They must also provide transparency as to how prices are determined on both a pre- and post-trade basis. Further, they must take steps to prevent disorderly trading conditions on their markets, including surveillance to identify potential market abuse and subsequent reporting.

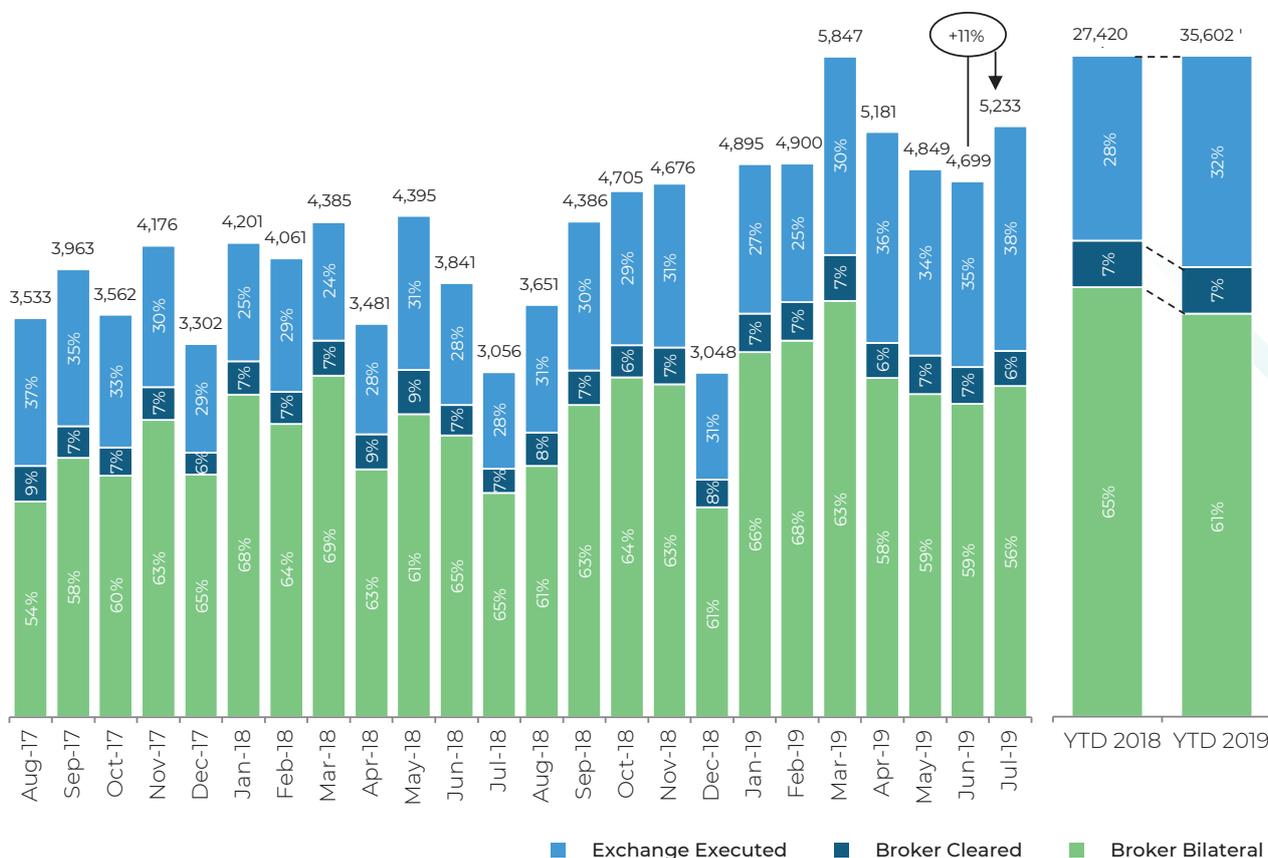
Broadly speaking, markets can also include those that are not regulated as trading venues but where regulated brokers facilitate clients to find buyers or sellers and may help to arrange the transaction. Sometimes, the resulting transactions are reported to an exchange and sometimes they are cleared by a central counterparty.

During liberalisation and other regulatory initiatives, energy markets played a role in encouraging more derivatives to be traded on regulated trading venues and be cleared by CCPs. Despite this, the largest volume of transactions in both power and gas derivatives is still not traded on exchanges. As the charts in Figures 6-9 demonstrate below, a higher volume of transactions is

facilitated by brokers, some of which may be regulated as operators of organised trading facilities. However, these charts do not show the OTC transactions that are traded directly between two parties which suggests that the proportion of transactions not executed on an exchange is significant. The charts show that the exchanges' proportion of transactions is increasing in many markets, but this is not the case in all geographies, market structures and asset classes. Some

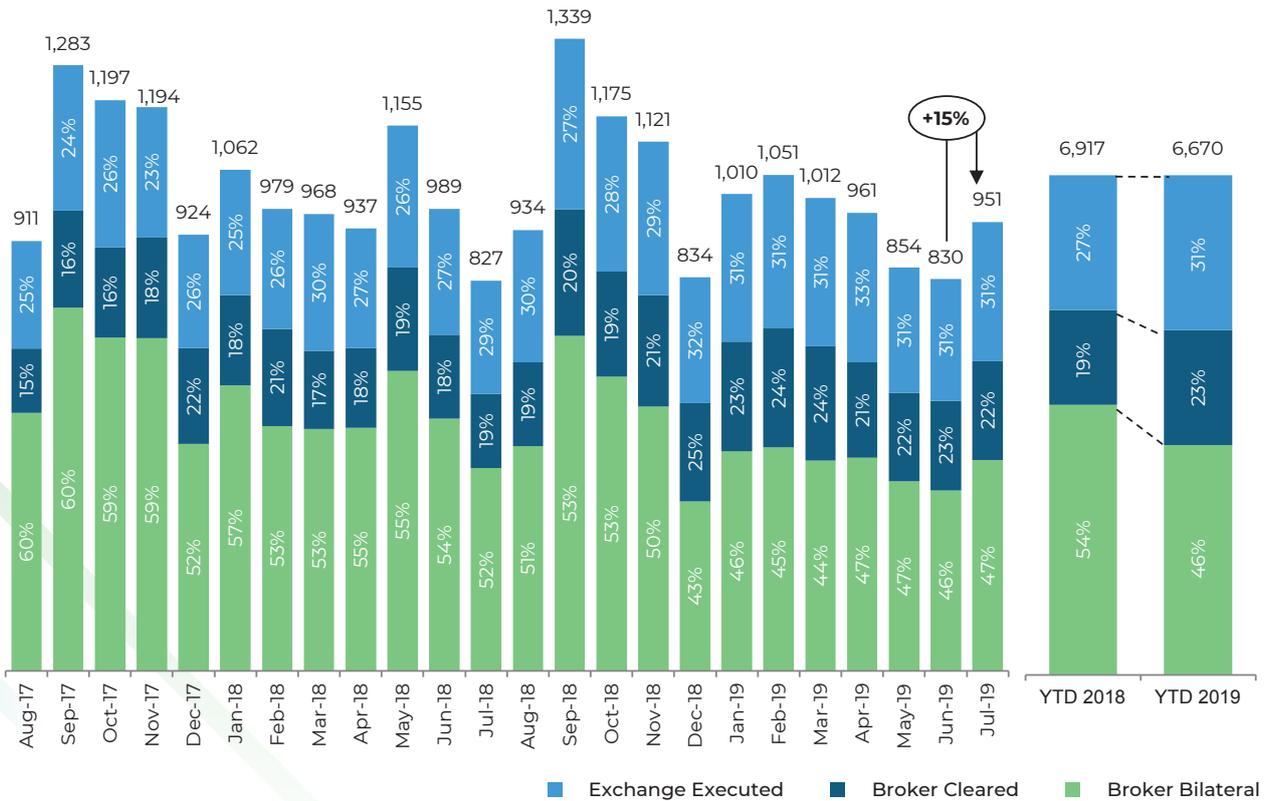
have instead observed a move away from trading venues of all types. Such volumes are reported to ACER but are not made public. It should be noted that the data in Figures 8-9 includes day ahead spot contracts as well as forwards and futures.

**Figure 6: Broker Bilateral / Broker Cleared / Exchange Executed Chart<sup>10</sup>**

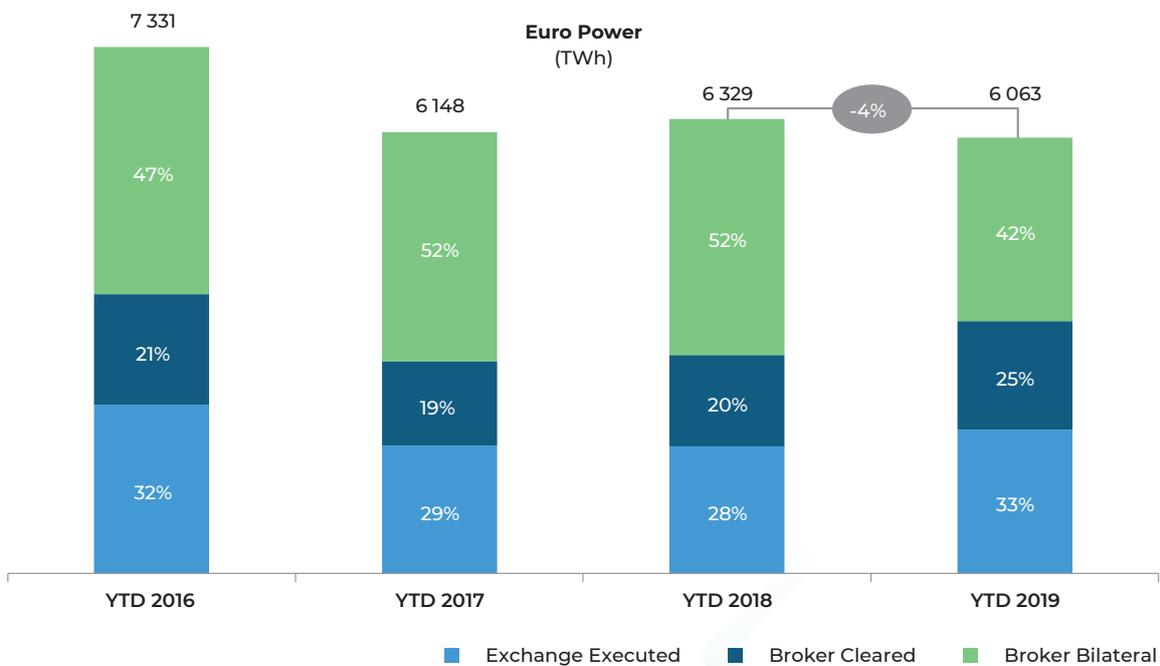


<sup>10</sup> Gas hub evolution figures are estimates based on Trayport analysis and market research, as at 31 July 2019 ([link](#)).

**Figure 7: Broker Bilateral / Broker Cleared / Exchange Executed Chart<sup>11</sup>**



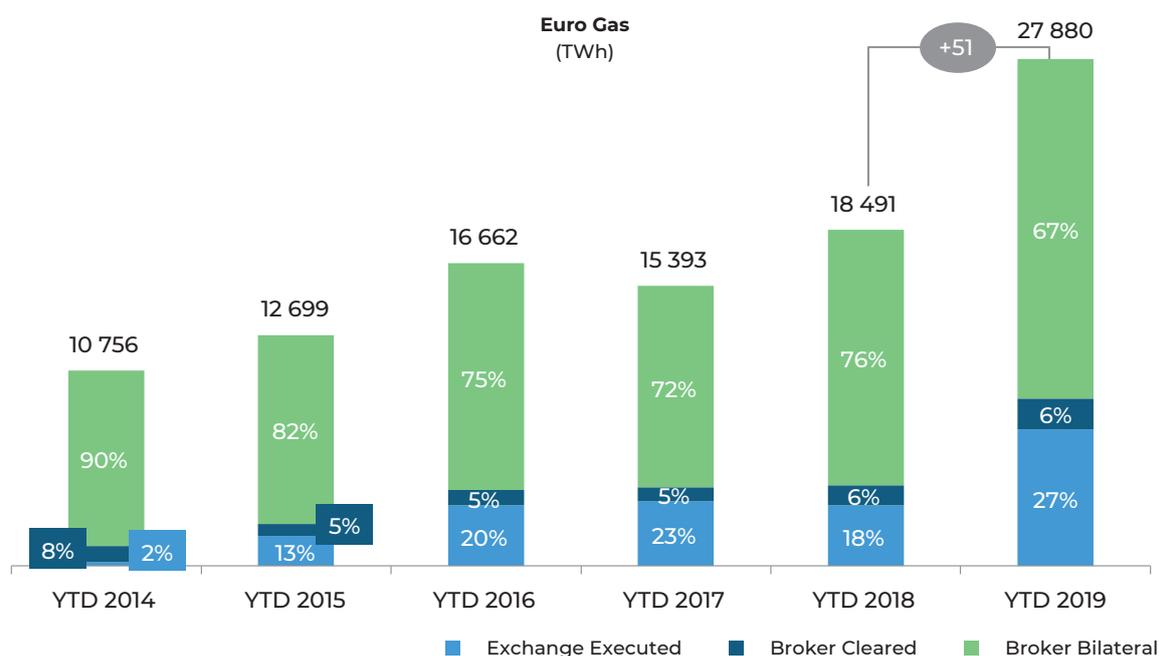
**Figure 8: European Power Market Composition: YTD Trends<sup>12</sup>**



<sup>11</sup> Power market evolution figures are estimates based on Trayport analysis and market research, as at 31 July 2019 ([link](#)).

<sup>12</sup> European power market composition YTD trend estimates are based on Trayport analysis and market research, as at 31 July 2019 ([link](#)).

**Figure 9: European Gas Market Composition: YTD Trends<sup>13</sup>**



### Contract types and their purposes

It is important to note that almost any type of energy transaction, be it spot, forward or future, and either financially or physically settled, can be traded OTC or on an exchange market, provided it is in place. In fact, OTC markets do compete with multilateral markets or Multilateral Trading Facilities (MTF) which causes particular difficulty in relation to derivatives where trading venues are relatively new compared to the markets for commodities themselves. Further, market operators have an interest in creating a safe trading environment and they are subject to regulation which makes them more expensive to operate and participate in. There are also differences in the way that regulatory requirements apply to different ways of trading, creating an un-level playing field.

In the wholesale energy market, the time to maturity, physical delivery versus financial settlement and trading OTC or on markets, are closely connected and interrelated. Financial forwards and futures are used to hedge or offset the risk

of price volatility of the short term physical day-ahead markets and various risks inherent in longer term supply contracts. As a result, there are a high number of common participants in each market. The exchanges provide a critical facility for hedging by designing standardised contracts relating to commonly traded commodities and providing the liquidity to make them available at a fair price on a continuous basis.

Financial contracts often use the spot price as their reference price while OTC contracts sometimes adopt the price as well as other reference terms on which exchange-traded contracts are traded. In some cases, contracts cannot be formed on exchanges because they are too large for the exchanges to accommodate without improperly affecting the market price. However, they can still be negotiated bilaterally and reported to an exchange or cleared so that they are taken into account in the market dynamics and subject to the benefits of risk management and reporting.

<sup>13</sup> European gas market composition YTD trend estimates are based on Trayport analysis and market research, as at 31 July 2019 ([link](#)).

## What is hedging?

Hedging is a technique of mitigating risk. It usually means locking in a price to buy or sell a commodity in the future and can be done by entering into a derivative. For example, power generators and gas producers enter into futures contracts to protect themselves against price fluctuations which may be caused by warm weather (which leads to falling prices) or a power plant failure, meaning that they might not be able to satisfy commitments under sale and purchase agreements. Through the futures contract, they fix the future price of their generation output as in the first example, or lock the price of energy in case they need to buy it in the market in the second.

More complex techniques may involve hedging risks arising from differences in the way power and gas are valued in different markets and risks that arise from transportation and storage.

In fact, hedging is a concept similar to insurance whereby one side of a transaction has interest in acquiring protection against certain risks (e.g. flooding) while the other side assumes that risk in exchange for a fee. The key difference between insurance and energy markets is that by entering into a futures contract both sides may compatibly manage their respective risks. For example, by selling a futures contract, generators lock in the long-term price of their output, while large energy consumers, through buying a futures contract, lock in the price of their future energy consumption costs.

Without the ability to hedge efficiently, many commodity producers or consumers may not be as able or willing to undertake some of their activities that are important for other reasons, such as agreeing to buy or sell forward.

As will be seen in subsequent sections of the report, financial services legislation has used the concept of hedging to distinguish trading that should be subject to the same requirements as financial instruments and which reflects the different underlying businesses of corporates versus financial institutions.

## 1.5. The (new) relationship with financial services regulation

This introduction to energy markets would not be complete without explaining how financial services legislation accommodates energy wholesale markets and brings with it a similar set of terms to those used above, but with specific and sometimes different meanings.

Due to the interlinkages between the spot, forward and futures markets, the use of such derivatives by commodities markets has increasingly been brought within the scope of financial services legislation. As such, financial institutions are becoming more involved in commodity transactions, commodity derivatives and, to a lesser extent, commodities. Commodity derivatives are treated as financial instruments, meaning that those who perform investment services and activities in relation to them are required to be authorised by a financial services regulator. This has been the case since 2007, however, and particu-

larly with the introduction of MiFID II in 2018, the definition of commodity derivative has widened, new investment activities have been introduced and the exemptions have narrowed.

## What is a commodity derivative?

The definition of commodity derivative written in MiFID II is used in the majority of financial services legislation. A commodity derivative is an option, future, swap, forward or any other derivative contract relating to commodities which:

- must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;
- can be physically settled provided they are traded on a regulated market, Multilateral Trading Facility (MTF) or Organised Trading Facility (OTF), except for wholesale energy products traded on an OTF that must be physically settled; or
- are not for commercial purposes, can be physically settled, are not otherwise mentioned in the previous point and have certain financial characteristics.

### Spot contract ≠ commodity derivative

A spot contract is not a commodity derivative. For these purposes, a spot contract is for the sale of a commodity, asset or right, under the terms of which delivery is made within the longer of two trading days or the standard delivery period generally accepted in the market for that commodity, asset or right. However, a contract shall not be considered a spot contract where, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the underlying commodity, asset or right is to be postponed and not to be performed within this period.

### Emission allowances and their derivatives = financial instruments

It should also be noted that MiFID II introduced emission allowances consisting of any units recognised for compliance with the requirements of the Emissions Trading Scheme as financial instruments. Derivatives on emission allowances are also financial instruments.

### Operating a multilateral system for commodity derivatives = authorisation required

The investment services captured by MiFID II include the operation of an MTF and an OTF, each of which is a multilateral system that brings together multiple buying and selling interests in commodity derivatives in a way that results in a contract. The difference is that an MTF operator has to match bids and offers on a non-discretionary basis in accordance with its rules and system logic, whereas an OTF operator is required to exercise discretion in whether or not to submit an order to its OTF and then whether to match it with any opposing interest. A person that operates either an MTF or an OTF must therefore be authorised. MiFID II also provides that exchanges in commodity derivatives be regulated as regulated markets. MiFID II imposes a number of obligations on the operators of these three types of trading venue.

Most financial services legislation captures commodity derivatives in general and imposes the same obligations on them as other financial instruments such as other types of derivatives and even transferable securities such as shares and bonds. It also tends to focus on commodity derivatives as opposed to spot transactions in their underlying commodities.

The following section of this report provides a more detailed overview of European financial services regulation that affects commodity derivatives, particularly energy contracts, energy markets and their participants.

## 1.6. Conclusion

In this chapter, we have introduced some fundamental aspects of how energy markets work and why energy derivative markets are subject to financial services regulation. To support decarbonisation efforts effectively, it is vital that both physical (spot) markets and forward (derivative) markets are functioning well to adapt to the changing energy mix and to facilitate cost efficient risk management.

In the remainder of this report, we use terms as they are defined in financial services legislation. This is important because, while the legislative definitions build on some of the dimensions discussed earlier in this section, such as type of settlement and time to maturity, any one dimension alone is not sufficient to determine whether a product falls within the scope of financial services regulation; thus the two need to be considered in combination. For example, a contract to buy gas for physical delivery more than two trading days ahead of the date on which the contract is agreed is a financial instrument if it is traded on a regulated market or has financial characteristics. These terms and others used in the report are set out in the Glossary.





## 2. Energy trading in the framework of EU financial services regulation

Sections 2 and 3 of this report seek to build on the explanation in section 1 and explain how financial services rules were expanded following the 2008-2009 financial crisis to cover energy derivatives trading in the EU and aspects of its interaction with physical energy markets.<sup>14</sup>

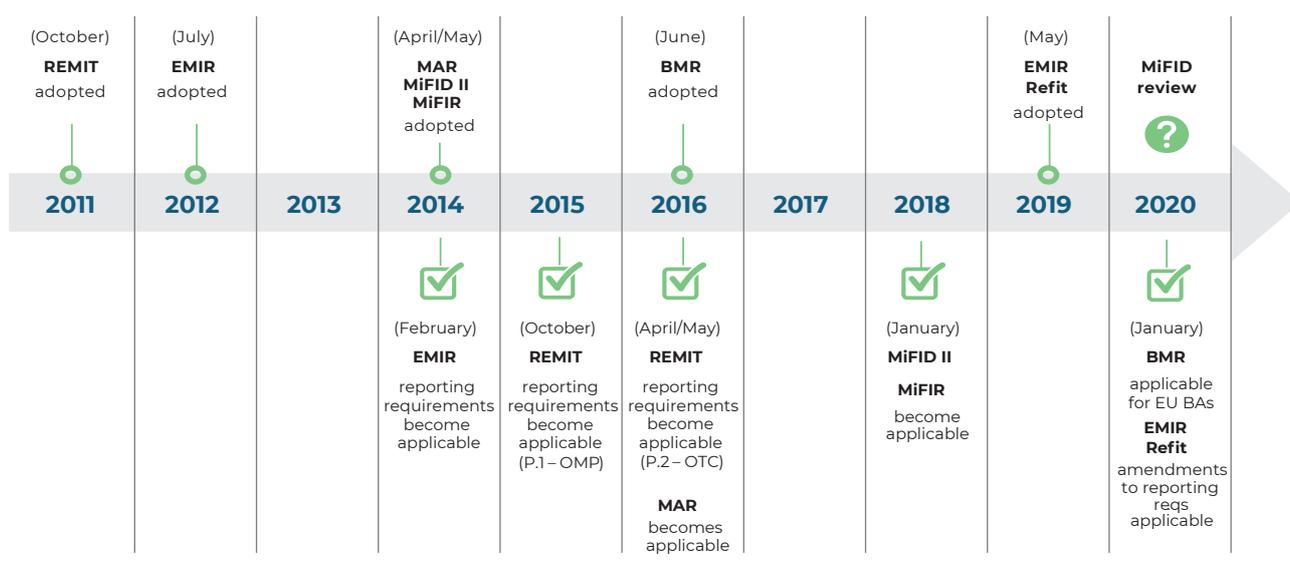
After providing an overview in this section of the regulatory requirements of the most relevant financial services regulation we review the policy objectives, as well as assess what the implementation has meant in practice for EU energy markets (Section 3).

## 2.1. Post-2008 expansion of financial services rules

Following the 2008-2009 financial crisis, legislators in the EU and other major jurisdictions embarked on an ambitious plan to reform the global derivatives markets. Though justified, given the role of certain OTC derivatives at the root of the financial crisis, the flow of financial services regulation that resulted was applied with a very broad brush. This brought certain traditionally unregulated market participants within the scope of the financial services regulatory framework. The explicit objective of legislative action was to bring “every product

and every market” into the scope of market oversight. The energy markets and their participants are a prime example. Not only had most of them been exempt from MiFID as “specialist commodity dealers” or for other reasons, but the market integrity of physical energy markets had not specifically been addressed by European financial or energy market legislation either.<sup>15</sup> Figure 10 gives an overview of the most recent development of the main pieces of legislation.

**Figure 10: Chronological development of the regulatory framework**



<sup>14</sup> In this respect, it is useful to clarify that trading of contracts for the physical supply of electricity or natural gas – which are purely commercial and non-financial in their nature - has not been impacted by financial regulations.

<sup>15</sup> MiFID refers to Directive 2004/39 (EC) of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

## 2.2. Financial services legislation relevant for energy trading

### a. REMIT and transparency for wholesale energy markets

We start with REMIT as it chronologically precedes the other relevant pieces of legislation. However, REMIT is also specific to the physical power and gas markets and therefore serves as a useful starting point before looking at the financial services legislation. Back in December 2010, the European Commission published its legislative proposal for a regulation on energy market integrity and transparency; it cited the development of power exchanges and standardised OTC contracts as a *“positive outcome of a decade of electricity and gas market liberalisation”*. These were to attract a broad spectrum of market participants including *“generators and suppliers, large energy users, pure traders, financial institutions and other trade facilitators”*. Therefore, the underlying reason for the proposed legislation was to create a *“basic tailor-made market abuse framework in the energy sector legislation for all*

*electricity and gas products not covered by the Market Abuse Directive”* (the predecessor of MAR and CS MAD).<sup>16</sup> Interestingly, and a symbolic difference in comparison to other pieces of legislation discussed in this report, the Commission services responsible for this proposal were the former Directorate General for Transport and Energy. Legislative review in the European Parliament was led by the Committee responsible for Industry, Research and Energy (ITRE), as opposed to the one dealing with financial services dossiers. Similar sectoral focus was represented by the Council.

Amongst the broad acquis of legislative acts setting out requirements applicable to transactions in energy financial instruments, REMIT is the only instrument providing a bespoke and tailored regime applicable to energy markets and their participants. As such, it introduces for the first time a legal framework for monitoring wholesale energy markets and prohibits market abuses such as insider trading and market manipulation.

#### REMIT: an overview

##### When?

Adopted in October 2011, REMIT came into force on 28 December 2011 with a phase-in approach applicable to reporting requirements. They were gradually introduced from 7 October 2015 and became fully applicable on 7 April 2016 when the obligation to report fundamental data on electricity and gas by transmission system operators became effective.

##### What?

REMIT deals with physical energy and energy derivatives trading. It applies to gas and power contracts (“wholesale energy products”) including – (1) contracts for the supply of electricity or natural gas where delivery is in the Union, (2) derivatives relating to electricity or natural gas produced, traded or delivered in the Union, (3) contracts relating to the transportation of electricity or natural gas in the Union, and (4) derivatives relating to the transportation of electricity or natural gas in the Union.

##### How?

REMIT introduces a legal framework for monitoring wholesale energy markets and prohibits market abuses such as insider trading and market manipulation. Market participants are obliged to register with their NRA and provide information to both the NRA and ACER for market monitoring purposes. Market participants are under an obligation to publicly and timely disclose inside information, which includes information in relation to the capacity and use of facilities, production, storage, consumption and transmission of electricity, natural gas or LNG. REMIT introduced comprehensive reporting requirements applicable to market participants which are obliged to provide ACER with a record of wholesale energy market transactions, including orders to trade.

<sup>16</sup> European Commission proposal for a regulation of the European Parliament and of the Council on energy market integrity and transparency (COM (2010) 726 final) ([link](#)).

## b. EMIR and a comprehensive framework for OTC derivative markets<sup>17</sup>

EMIR was introduced as part of the response to the 2008-2009 financial crisis, with the aim of reforming the OTC derivatives markets to improve their transparency, prevent market abuse and reduce systemic risks in markets perceived to be more opaque and complex. While EMIR applies to derivatives as opposed to physical energy, its scope is wider than just financial services as it captures any person that is party to a derivative, whether regulated or not. Proposed by the European Commission in September 2010, the regulation on OTC derivatives, CCPs and trade repositories was designed to introduce into Union law the commitments agreed in Pittsburgh in 2009 by the G20 leaders. In particular, they pledged that *“all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through CCPs by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher requirements.”*<sup>18</sup> Providing context for the introduction of this new legislation, the Commission highlighted the role that Credit Default Swaps (CDS) played during the crisis.

Shifting from its initial focus on CDS, both the legislative proposal and the final legislative act expanded the scope of OTC derivatives subject to the new requirements to *“all standardised OTC derivatives”*, arguably to align the legislation with the G-20 commitments. Justifying the inclusion

*of NFCs within the scope of the proposed legislation, the Commission did acknowledge that “derivatives activities are generally assumed to cover those derivatives that are directly linked to their commercial activity rather than speculation.”* In an attempt to introduce a certain level of proportionality, recital 29 EMIR mandated ESMA to *“consult all relevant authorities, for example ACER, in order to ensure that the particularities of those sectors are fully taken into account”* when assessing which NFCs should be subject to the legislation. Recital 29 EMIR required the Commission to *“assess the systemic importance of the transactions of non-financial firms in OTC derivative contracts in different sectors, including in the energy sector.”*<sup>19</sup> Interestingly, amendments put forward to this recital during legislative review by the European Parliament Committee on Economic and Monetary Affairs (ECON), called for the withdrawal of EMIR should a tailored sectoral legislation be adopted.<sup>20</sup> However, this attempt to further streamline application of the new legislation did not survive the trilogue negotiations with the Member States and the Commission.

According to data published by ESMA, commodity derivatives account for 1% of the value of the total notional amount outstanding in 2018 (and energy derivatives are only one of the sub-asset classes of a broader commodity derivatives grouping).<sup>21</sup>

17 EMIR refers to Regulation (EU) 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

18 Comments from the G20 leaders' statement, which was agreed at the Pittsburgh summit in September 2009.

19 ESMA EMIR Review Report No 1: Review on the use of OTC derivatives by non-financial counterparties (13 August 2015) ([link](#)). ESMA concluded that *“when compared to financial counterparties, the systemic relevance of NFCs appears limited. However, when the positions of NFCs are disaggregated (per asset class, per counterparty) the data show that NFCs are active and significant players mainly in the Commodity OTC derivatives market and, to a lesser extent, in the FX OTC derivatives market. It is shown that those active market players are not necessarily NFC above the clearing threshold (NFC+), due to the current feature that hedging transactions are not counted towards the clearing thresholds.”*

20 Draft European Parliament legislative resolution on the proposal for a regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories ([link](#)). Recital 16: *“Should a comparable set of EU rules tailored to individual sectors come into force, the Commission should immediately consider whether the sector should be removed from the scope of this Regulation and should put forward appropriate legislative proposals.”*

21 ESMA Annual Statistical Report: EU Derivatives Markets 2019 ([link](#)).

## EMIR: an overview

### When?

Adopted on 4 July 2012, EMIR became applicable on 16 August 2012, with a number of provisions being subject to a phase-in approach (including application of variation margin requirements). On 4 May 2017, the European Commission proposed targeted amendments to EMIR. They are commonly known as “EMIR Refit” or “EMIR 2.0”.<sup>22</sup> Formally adopted after relatively quick legislative review on 20 May 2019, EMIR Refit became applicable on 17 June 2019. It introduced a series of amendments to EMIR, some of which have been long-advocated by market participants.

### What?

The legislation sets out requirements that are applicable to both Financial Counterparties (FCs) and Non-Financial Counterparties (NFCs) that enter into derivatives contracts. The exact requirements differ depending on the type of counterparty and the value of their exposures in OTC derivatives.

### How?

#### Reporting requirements

They are applicable to OTC and Exchange-Traded Derivatives, FCs and NFCs. Any derivative contract concluded, modified or terminated must be reported to a trade repository no later than the next working day. EMIR Refit introduces certain targeted amendments to these provisions and makes FCs solely “responsible and legally liable” for reporting on behalf of both counterparties when their counterparty is an NFC that falls below each of the five prescribed clearing thresholds (an “NFC-”).

#### Clearing obligation

FCs and NFCs exceeding any of five clearing thresholds relating to different asset classes (“NFCs+”) must clear OTC derivative contracts of a class that has been declared subject to the clearing obligation by ESMA through a CCP. EMIR Refit eliminated the infamous “breach-one-clear-all” approach so that NFCs are only required to clear OTC derivatives in the asset class whose threshold they have breached.

#### Risk mitigation

All counterparties must confirm the details of all non-cleared OTC derivative contracts and perform portfolio reconciliation. In addition, all FCs and NFCs+ must exchange collateral (in the form of initial and variation margin) and hold an appropriate level of capital to manage risks not covered by the exchange of collateral.

#### Bank guarantees

In addition, following the entry into force of EMIR and until March 2016, NFCs were allowed to provide non-collateralised commercial bank guarantees as collateral to CCPs. This temporary exemption was broadly used by participants in Nordic power markets to cover transactions in energy derivatives cleared by CCPs. ESMA's decision in November 2015 not to extend it beyond the original expiry date meant the use of such guarantees was no longer possible, with subsequent negative consequences for the market.

<sup>22</sup> EMIR Refit refers to Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories.

### c. MiFID II and regulation of commodity derivatives markets and their participants<sup>23</sup>

With EMIR provisions focusing on the OTC derivatives markets, the post-crisis reform led by the European Commission was set to address broader European financial services markets. Therefore, while European legislators were in the midst of discussing future provisions of EMIR, in October 2011 the European Commission published proposals for another landmark piece of financial services markets reform. Consistent with a trend to adopt more legislation in the form of directly applicable regulations rather than directives, the Commission proposed a package of proposals amending the 2004 Markets in Financial Instruments Directive (MiFID); this package consisted of one draft regulation and one draft directive. Following legislative review and formal adoption by the European Parliament and by the Council, this legislation is known as the MiFID II/ MiFIR package.

MiFID II is a core piece of financial services legislation which defines the scope of investment services and activities which, when undertaken in relation to financial instruments, requires authorisation. As such, provisions of MiFID II are critical to determining the scope of products and persons falling within the mandate of other financial services legislation such as EMIR or legislation setting out prudential requirements. MiFID II and MiFIR also include a wide range of organisational, conduct and market infrastructure obligations, many of which are relevant to investment firms that trade energy and other commodity derivatives. However, for the purposes of this report, we focus on those provisions which are most important to both the energy markets and the market participants trading therein, whether they are regulated or not.

#### Ancillary activities exemption

Similar to EMIR, legislative changes that resulted in the MiFID II framework for commodity derivatives were driven (to some extent) by international developments. Specifically, the April 2011 G20 communication that “*stressed the need for participants on commodity derivatives markets to be subject to appropriate regulation and supervision*” was cited by the Commission as a reason behind amending the MiFID exemptions.<sup>24</sup> One of the objectives of the recast MiFID, therefore, was to “*limit the exemptions more clearly to activities which are less central to MiFID and primarily proprietary or commercial in nature.*”<sup>25</sup> The ancillary activity exemption replaced the previous generous and relatively simple commodity dealer exemption with a complex, threshold-based test explained further below. Non-financial energy market participants trading in OTC and/or ETD contracts must now review their trading activity against the applicable thresholds on an annual basis and satisfy certain other requirements if they wish to rely on it.

#### REMIT carve-out

Similar to the scope of financial instruments, the intention was to widen the net of legislation. However, at the same time there was recognition of the need to limit the regulatory burden applicable to energy market participants which resulted in the REMIT carve-out. However, as set out in recital 10 MiFID II, “*the limitation of the scope concerning the commodity derivatives traded on an OTF and physically settled should be limited to avoid regulatory arbitrage.*” Discussions leading to the adoption of the REMIT carve-out attracted a lot of attention and mixed views. The adopted REMIT carve-out was ultimately a compromise that enabled the legislators to widen the scope of MiFID II while still allowing for some limited exemptions for wholesale energy products.

<sup>23</sup> MiFID II refers to Directive 2014/65 (EU) of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.

<sup>24</sup> See point 6 of the Final Communiqué, Meeting of G20 Finance Ministers and Central Bank Governors (15 April 2011) Washington DC ([link](#)).

<sup>25</sup> As set out by the European Commission in an explanatory note to October 2011 MiFID II proposal (Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (Recast) ([link](#))).

One of the key considerations was that it applies to products which are subject to REMIT requirements and, as such, are not entirely outside the regulatory perimeter.

### Position limits

The introduction of a position limits regime in European legislation was driven by international developments and G20-level commitments. The G20 November 2011 summit called for market regulators to “*have and use formal position management powers, among other powers of intervention, including the power to set ex-ante position limits, as appropriate*”.<sup>26</sup> The introduction of position limits for commodity derivatives was one of the most politicised elements of the MiFID II legislative review. This discussion was largely driven by alleged speculative activities of financial institutions in agricultural derivatives markets (corn, wheat and rice in particular) and their implication for the high prices of those and other agricultural products. However, this argument was by no means limited to agricultural products, with legislators and stakeholders also pointing to ‘*excessive speculation*’ in other markets, such as metals. Far less attention was given to the energy markets.

Although many exchanges already imposed position limits, the Commission considered that: “*A harmonised position limits regime is needed to ensure greater coordination and consistency in the application of the G20 agreement, especially for contracts that are traded across the Union.*” Therefore, competent authorities are required to determine limits on the size of positions that market participants can enter into to “*prevent market abuse, including cornering the market, and to support orderly pricing and settlement conditions including the prevention of market distorting positions*”. The Commission considered that “*such*

*limits should promote integrity of the market for the derivative and the underlying commodity without prejudice to price discovery on the market for the underlying commodity*”.<sup>27</sup>

The European Commission referred to the then proposed expansion of MiFID II to commodity derivatives markets as “*targeted improvements*” that were necessary “*in order to improve oversight and transparency of commodity derivative markets in order to ensure their function for hedging and price discovery, as well as in light of developments in market structures and technology in order to ensure fair competition and efficient markets*”.<sup>28</sup> However, the resulting regime is extremely broad in scope as it applies to all commodity derivatives contracts that are traded on European trading venues and to Economically Equivalent OTC contracts. At the time of writing, ESMA’s record listed 23 liquid electricity derivative contracts and 10 natural gas contracts traded on European trading venues.<sup>29</sup>

The methodology was designed to give competent authorities sufficient flexibility to “*take into account the variations among different commodity derivatives markets and the markets in the underlying commodities*”.<sup>30</sup> While it was also recognised that “*competent authorities should take into account in applying the methodology the time required to develop and attract liquidity to both new and existing commodity derivatives*”<sup>31</sup>, recent criticism would suggest that this has not been achieved in practice.

Interestingly, the institutional perception of the driving reason behind the introduction of the position limits regime did not change following the adoption of the legislation. In December 2016, when the European Commission announced the

26 See point 18 of the Communiqué following the G20 Leaders’ Summit in Cannes (03-04 November 2011) ([link](#)).

27 Recital 127 MiFID II.

28 European Commission Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (Recast) ([link](#)).

29 ESMA list of bespoke position limits (version 24 September 2019) ([link](#)).

30 Recital 1 Commission Delegated Regulation (EU) 2017/591 on the application of the position limits regime to commodity derivatives (CDR 2017/591).

31 Recital 17 CDR 2017/591.

adoption of draft secondary legislation for the position limits framework, the official press release read that the *“regulatory standard on position limits provide regulators with the full set of tools to ensure that food price speculation is curbed.”*<sup>32</sup> Suffice it to say, there was no reference to wholesale energy products in that context.

### **Hedging exemption under MiFID II/ MiFIR framework<sup>33</sup>**

The protection against *“excessive commodity price volatility”* was one of the underlying reasons behind the application of the position limits regime to the broadest possible scope of commodity derivatives. Yet, the legislators agreed to introduce limited exemptions that recognise and protect genuine hedging activity by non-financial entities from excessive compliance burdens. The position limits regime is therefore not applicable to positions held *“by or on behalf of a non-financial entity and which are objectively measurable as reducing risks directly relating to the commercial activity of that non-financial entity”*. As such, this “hedging” exemption recognises the risk-mitigation role that energy and other commodity derivatives play for non-financial market participants.<sup>34</sup> The legislators rejected industry arguments that called for a more expansive application of the hedging exemption and the possibility for financial institutions to rely on an exemption in justified circumstances. Given the highly politicised nature of the surrounding debate on position limits, allowing the hedging exemption to be used by financial institutions seemed politically impossible at the time. To further restrain the use of the hedging exemption, the legislators made it subject to obtaining prior approval from a relevant competent authority.

The legislators transferred the same hedging exemption to the pre-trade transparency regime for derivatives. Although the legislators were not as clear as usual in expressing their policy objectives, one must assume that the underlying reason for its adoption stems from a willingness to make MiFID II and MiFIR requirements more fit-for-purpose for non-financial market participants.

Finally, the hedging exemption is important in the context of the ancillary activity exemption in so far as *“transactions in derivatives which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity”* do not count towards the thresholds.

However, it should be noted that the operation of the exemption is slightly different depending on its purpose. For example, a non-financial entity must have a hedging policy if it wants to rely on the ancillary activity exemption, whereas it must seek the approval of the NCA for position limits.

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32 Commission press release ([link](#)).

33 MiFIR refers to Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.

34 Commission Staff Working Paper accompanying the Commission Communication: Ensuring efficient, safe and sound derivatives markets, 3 July 2009 (SEC (2009) 905 final) ([link](#)). In this document, under a section addressing the effectiveness of risk mitigation measures in derivatives markets, the Commission noted that *“achieving more stability and transparency in commodity derivatives requires developments outside the post-trade area as well. A significant number of participants in these markets are not financial firms, but commercial producers hedging their price risks. Therefore, legislation designed for the financial sector may not be adequately tailored to their activity and risk profile. Indeed, this is reflected in a number of exemptions from EU financial legislation, such as MiFID and CRD. Ensuring access of such firms to commodity derivative markets is important as it supports building competition within the recently liberalised EU commodity markets (e.g. electricity and gas). It also contributes to market liquidity”*.

## MiFID II: an overview

### When?

Adopted on 15 May 2014, MiFID II became applicable on 3 January 2018, following a one year delay of its original implementation date.

### What?

MiFID II establishes a harmonised framework for markets regulation in the European Union. In addition to amending the available exemptions, enlarging the scope of financial instruments and introducing comprehensive position limits and a management and reporting regime for commodity derivatives, MiFID II also provides a broad overhaul of the European market infrastructure regime.

### How?

#### Ancillary activity exemption

MiFID II removed the previously existing exemption from authorisation requirements for persons whose main business consisted of dealing on own account in commodities and/or commodity derivatives.<sup>35</sup> It also tightened up the exemption for persons dealing in certain commodity derivatives, provided that this activity was ancillary to their main business, by introducing a complex set of thresholds to measure whether such activity is ancillary and making it subject to a notification requirement.

#### Scope of financial instruments and REMIT carve-out

MiFID II amended the scope of financial instruments to cover physically-settled commodity derivatives traded on OTFs (in addition to those traded on regulated markets and MTFs).<sup>36</sup> This is subject to a limited exemption for *“wholesale energy products traded on an OTF that must be physically settled”*, which remain outside the scope of European financial services regulation.

#### Position limits for commodity derivatives

MiFID II introduced a requirement for NCAs, based on methodology developed by ESMA, to establish and apply position limits on the size of a net position which a person can hold at any time in commodity derivatives traded on trading venues and in EEOTC contracts. The limits apply to all positions held by a person and those held on their behalf at an aggregate group level. The position limits regime as introduced by MiFID II applies to all commodity derivative contracts, cash and physically settled.

#### Hedging exemption

The MiFID II “hedging exemption” concept is applicable to the ancillary activity threshold calculations, position limits and MiFIR pre-trade transparency requirements. Position limits do not apply to positions in commodities held by, or on behalf of, non-financial entities which are *“objectively measurable as reducing risk directly related to the commercial activity of that non-financial entity”* where the non-financial entity has applied for an exemption. Derivatives transactions entered into by NFCs that meet the conditions of being *“objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the NFC or of that group”* are exempt from pre-trade transparency requirements.

<sup>35</sup> Article 2(1)(i) and (k) of MiFID.

<sup>36</sup> See Annex I, Section C6 of MiFID II.

## d. MiFIR and pre-trade transparency requirements

### Pre-trade transparency for energy derivatives

As noted above, MiFIR is the second part of the MiFID II package and contains the obligations that the European Commission considered necessary for the highest level of harmonisation across Member States. They include transparency and transaction reporting. The pre- and post-trade transparency regime was introduced to enable all market participants to understand the depth of buy and sell interest and the price and volume at which transactions are entered into. By increasing the understanding of market participants, the regime would facilitate price formation. The original regime introduced by MiFIR applied only to transactions in shares, irrespective of the method of their execution. Following a review of the functioning of the MiFID transparency framework, the European Commission proposed to extend the regime to other equity-like financial instruments as well as bonds, structured finance products, emission allowances and derivatives. As explained by the European Commission at the time of presentation of the MiFIR legislative proposal, *“extension is justified by the fact that the existing level of transparency of these products which are, in most cases, traded OTC is not always considered sufficient”*.<sup>37</sup> However, the regime was intended to be appropriately tailored and to *“take full account of the principle of proportionality, being adequate to reach the objectives and not going beyond what is necessary in doing so”*. Specifically, in respect of *“the new transparency rules that could be applied to bonds and derivatives markets, the revision advocated for a carefully calibrated regime that will take into consideration the specificities of each asset class and possibly each type of derivative”*. Eventually MiFIR extended this transparency obligation to a much broader set of financial instruments, including derivatives – and comprising all asset classes thereof. It was consi-

dered necessary to *“introduce an appropriate level of trade transparency [...] in order to help the valuation of products as well as the efficiency of price formation.”*<sup>38</sup>

Pre-trade transparency requirements and particularly their application to negotiated trades varies in respect of equity and non-equity instruments. While secondary legislation defines ‘negotiated trades’ in the context of pre-trade transparency waivers for equity instruments, the MiFIR framework does not include any similar provisions applicable to non-equity instruments. This appears to be a legislative oversight as negotiated trades are commonly used in commodity derivatives markets, including for energy derivatives transactions. In light of the lack of explicit provisions, ESMA Q&A guidance provides that negotiated (or *“pre-arranged”*) trades in non-equity instruments can be undertaken subject to meeting the conditions for the specific waivers from the pre-trade transparency regime as set out in MiFIR (i.e. the LIS waiver, the waiver for instruments that do not have a liquid market, the exchange-for-physical waiver or the package order waiver).<sup>39</sup> Such transactions can also benefit from the hedging exemption, subject to applicable conditions. In June 2019 ESMA issued a dedicated supervisory briefing to address the issue that pre-trade transparency provisions applicable to negotiated trades in commodity derivatives are not applied in a consistent manner across the EU Member States.

37 COM MiFIR proposal: [\(link\)](#).

38 Recital 15 MiFIR.

39 ESMA Questions and Answers on MiFID II and MiFIR transparency topics (version: 02 October 2019) [\(link\)](#).

## MiFIR: an overview

### When?

Adopted at the same time as MiFID II, MiFIR also became applicable on 3 January 2018. Pre-trade transparency requirements in respect of negotiated trades became applicable as of 1 January 2020.<sup>40</sup>

### What?

MiFIR introduces directly applicable requirements, including a pre- and post-trade transparency regime to a broad range of equity-like and non-equity financial instruments (including energy derivatives).

### How?

#### Pre-trade transparency

Market operators and investment firms operating trading venues must make public their bid and offer prices and the depth of trading interests at those prices that are advertised through their system and traded on a trading venue. This also includes actionable indications of interest. This information must be publicly available on a continuous basis during normal trading hours. MiFIR sets out a limited exemption to the pre-trade transparency requirement, whereby an NCA can grant waivers for certain types of orders such as those for Large In Scale, derivatives, those “for which there is no liquid market”, and those for the purpose of executing exchange-for-physical and package transactions (subject to conditions). The relevant thresholds are set out in secondary legislation.<sup>41</sup>

## e. Regulatory reporting and a tale of many tales...

One common theme across all pieces of European financial services legislation discussed so far (REMIT, EMIR, MiFID II and MiFIR), is that they all contain an obligation for regulatory reporting. Derivatives, including energy derivatives, are reportable under all these regimes but for different reasons; these slight differences in reporting obligations dictate that different data should be reported, to different persons and in different ways as set out below.

The scope of the reporting obligations is also different, reflecting their purpose and the legislation within which they sit. For example, reporting under REMIT is focused on derivative contracts that relate to electricity or natural gas produced, traded or delivered in the EU while under MiFID II reporting is limited to commodity derivatives. On the other hand, reporting under EMIR covers all derivative contracts, including OTC and ETD contracts, irrespective of the asset class; the various types of

reporting under MiFIR generally extend to all financial instruments traded on a trading venue. This, plus the fact that different obligations apply to different occurrences as set out below, inevitably leads to overlaps on the one hand, and discrepancy of requirements applicable to the same types of market participants on the other.

<sup>40</sup> *Ibid.*

<sup>41</sup> See Commission Delegated Regulation (EU) 2017/583 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives.

## Purpose of reporting obligations

### **REMIT**

#### *How?*

Market participants must provide ACER with a record of their wholesale energy transactions, including orders to trade.

#### *Why?*

To enable ACER and the NCAs to detect and deter market abuse in the wholesale energy markets.

### **EMIR**

#### *How?*

Counterparties to a derivative must report counterparty and contract data to a trade repository no later than the working day following conclusion, modification or termination of the derivative.

#### *Why?*

To ensure information on derivatives is easily accessible to NCAs and ESMA, as well as to other authorities who need to understand the level and nature of risk being assumed by one counterparty to another.

### **MiFID II**

#### *How?*

Trading venue operators must report positions to their NCAs daily and publish aggregate positions weekly. To assist them, operators require that their participants report their own positions and those of their clients.

#### *Why?*

This is to enable the NCAs to monitor compliance with the position limits regime.

### **MiFIR**

#### *How?*

Investment firms are required to report the details of certain transactions (mainly those traded on a trading venue) to an ARM. Trading venue operators and systematic internalisers must report reference data to their NCA and publish pre-trade information about orders. Trading venue operators and investment firms must report transactions executed post-trade – this data can be published through an approved publication arrangement. Transparency is technically disclosure rather than reporting but is often treated by firms as if it were reporting.

#### *Why?*

NCAs use transaction reporting data to identify and investigate potential instances of market abuse. Reference data is used to create standardised references for financial instruments, and used in transaction and other reports. Transparency data are intended to assist the markets with price formation.

**Figure 11: Duplication between reporting regimes**

	REMIT	EMIR	MiFID II/MiFIR
Orders to trade	✓(ACER)		
Transactions	✓(ACER)	✓(TR)	✓(ARMs)
Positions		✓(TR)	✓(NCAs/ trading venues)
Exposures		✓(TR)	
Reference data			✓(ESMA)

Note: Figure 11 does not include pre- and post-trade transparency obligations in MiFIR as these are publication as opposed to reporting obligations.

ESMA and the Commission have tried to mitigate the effect of this duplication but this is quite difficult to achieve effectively given the fundamental differences between reporting requirements. For example, the REMIT reporting requirement applies unless such derivative contracts are already reported under EMIR or MiFIR.<sup>42</sup> However, the scope of reporting obligations under REMIT also extends to orders to trade, which are not repor-

table under EMIR. Consequently, market participants entering into OTC derivative transactions in derivatives on electricity produced in the EU can report such transactions under EMIR; however, an order to trade – relating to exactly the same contract – must be reported under REMIT. This is just one example of the additional effort created by fragmented co-existence of regulatory reporting regimes.

## 2.3. Other relevant regulatory initiatives

The examples of legislative and regulatory requirements cited on the previous pages are those that have had the greatest impact (be it financial, operational or otherwise shaping behaviour and business development) on physical energy and energy derivative market participants and infrastructure operators. The broader policy and regulatory environment also has significant implications for the sector and will continue to shape its development in the near future. The volume of this report does not allow for a more detailed presentation of the complete landscape of financial services regulation of relevance for the energy sector. However, those mentioned in the chronological

snapshot timeline (Figure 10) deserve comment as their requirements apply, to a certain extent, in relation to physical energy and/or energy derivatives markets and their participants. This relates in particular to the Benchmark Regulation (BMR) and the Market Abuse Regulation (MAR). Finally, we conclude this overview with a brief mention of prudential requirements applicable to financial participants in energy markets, as well as some international and Euro-related considerations.

<sup>42</sup> Guidance on the application of the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT), 5th Edition, 8 April 2020 ([link](#)).

## a. BMR and access to regulated benchmarks

The BMR sets out a framework for administration and governance of benchmarks and captures various types of benchmarks (financial, interest rate, regulated data and commodity). These are both major, LIBOR-type 'critical' benchmarks, as well as small, non-significant benchmarks. While the bulk of the requirements fall on the administrators of benchmarks, users (such as energy exchanges listing futures contracts referencing a benchmark), need to check that the benchmarks they will be using from 1 January 2020 (1 January 2022 for third-country administrators) are authorised or registered with an NCA (or recognised or endorsed for third country benchmarks). At the time of writing this report, the BMR was subject to review by the European Commission.

## b. MAR and market manipulation prohibitions

Adopted in parallel to MiFID II and MiFIR, MAR has traditionally been overshadowed in public debate by the BMR. In practice, MAR sets out some very stringent anti-market abuse requirements wherein non-compliance carries a risk of administrative measures and sanctions as well as potential prosecution and criminal penalties. MAR prohibits insider dealing, the unlawful disclosure of inside information and market manipulation in a wide range of financial instruments.

MAR provides specific definitions of what constitutes "inside information" in relation to commodity derivatives and emission allowances. The definition of "inside information" under MAR creates an overlap with a similar definition under REMIT that is applicable to wholesale energy products.

This overlap in both definition and application to energy derivatives and spot energy transactions has led to uncertainty for market participants as the MAR definition of inside information is much broader than under REMIT. That said, at the time of writing this report, MAR was subject to review by the European Commission and these considerations were flagged by Europex in its consultation response.<sup>43</sup> ACER has also since updated its guidance on the application of the definition of inside information in REMIT to align it with that in MAR and provide further clarity on the matter.<sup>44</sup>

The MAR prohibition of market manipulation extends to spot commodity transactions and certain physically-settled commodity forward contracts, as well as behaviour in relation to benchmarks. Energy market participants (whether regulated or not) who deal on own account in commodity derivatives are obliged to detect and report suspicious orders and transactions in financial instruments to their NCA.

## c. Prudential requirements

While not directly captured by the European prudential legislation for credit institutions and investment firms, energy markets are indirectly affected as any developments affect a large part of their client base. CRR and the recently adopted equivalent for investment firms, IFR, set prudential (including capital adequacy) requirements for those financial institutions in scope.<sup>45</sup> Whilst the IFR provisions are yet to be implemented, they are broadly considered a positive development as the investment firm community has long been calling for a more bespoke prudential regime and differentiated treatment than credit institutions.

43 Europex response to the ESMA consultation on the review of the Market Abuse Regulation (MAR) ([link](#)).

44 Guidance on the application of the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT), 5th Edition, 8 April 2020 ([link](#)).

45 CRR refers to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms (OJ L 176) (27 June 2013) ([link](#)), amended by Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements (OJ L 150) (07 June 2019) ([link](#)).

Prudential regulation for banks is yet another story, a recent EBA assessment estimates an additional 23.6% increase of minimum capital requirements applicable to credit institutions stemming from the full implementation of the final Basel III standard in European law.<sup>46</sup> The proposed removal of all exemptions from the credit valuation adjustment risk calculations currently applicable to certain transactions (including transactions with NFCs-) may have an effect on banks' willingness to conduct business in energy derivative markets, among other asset classes.<sup>47</sup> These exemptions were added to CRR by European legislators in a divergence from the original Basel standard to, in part, incentivise banks' entering into transactions with NFCs.

#### **d. Third country access and the Euro**

Finally, energy exchanges, by virtue of being part of a broader European financial markets infrastructure, are affected by developments concerning cross-border provision of financial services and engagement in investment activities. With a renewed push for the finalisation of the Capital Markets Union during the Commission's 2019-2024 mandate, one of the fundamentals for making Europe a competitive and attractive marketplace should be to facilitate access for both participants located or established in the EU and also for third-country firms that seek access to European markets. Conversely, recently adopted changes to the MiFIR third-country regime seem to point in the opposite direction. Inherently linked with this issue is a need for a transparent, predictable and rule-based harmonised framework governing access to European mar-

kets for third-country firms. However, the current equivalence-based approach, though technical in nature, is not free from political interference. For example, in 2019, the Commission allowed an extension of a temporary decision granting equivalence to Switzerland with the condition that Switzerland adhere to broader political demands and, in particular, approve a comprehensive agreement governing the bilateral relations between Switzerland and the EU. Failure to do so resulted in the expiry of the equivalence decision for Switzerland at the end of June 2019. On a more macroeconomic policy level, initiatives such as the evaluation of the role of the Euro in the field of energy, and any policy action that may follow, will be of structural importance for the sector in the mid to longer-term.<sup>48</sup> The role of the markets in boosting the Euro in global markets will be critical as there is currently no silver-bullet solution in the pipeline.

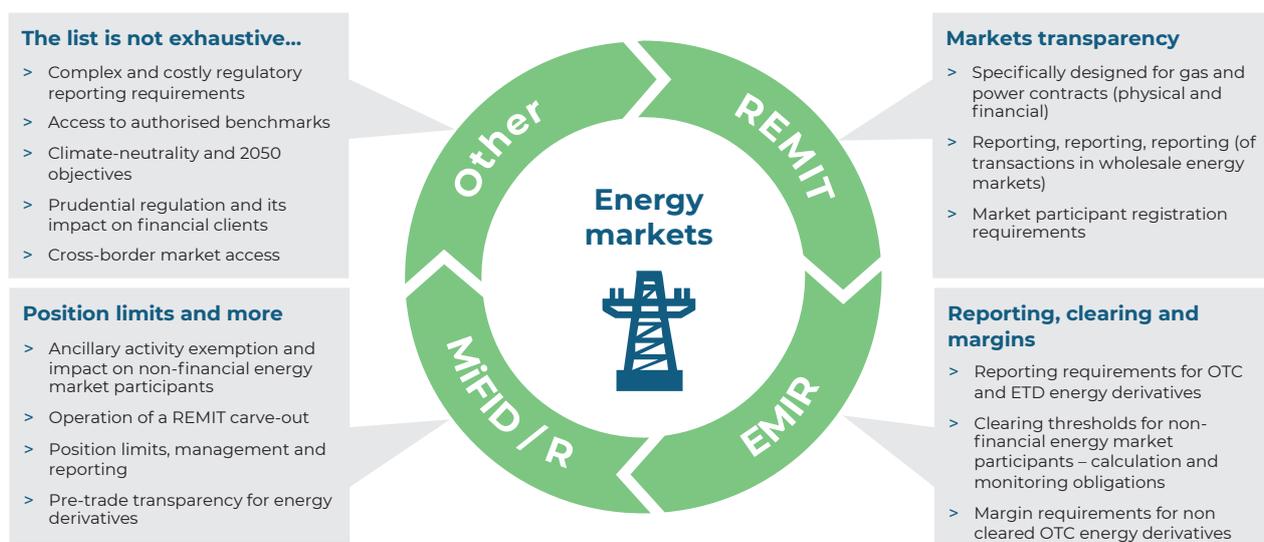
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46 EBA Basel III Reforms: Impact Report and Key Recommendation – Macroeconomic Assessment, Credit Valuation Adjustment and Market Risk (04 December 2019) ([link](#)).

47 EBA Policy Advice on the Basel III Reforms on Credit Valuation Adjustment (CVA) and Market Risk (EBA-Op-2019-15) (04 December 2019) ([link](#)). Currently Article 382(4) CRR allows a bank to exempt certain transactions from the calculation of capital requirements for the purpose of credit valuation adjustment risk. These include: (1) Transactions with non-financial counterparties below the EMIR clearing threshold; (2) Transactions between clearing members and clients in the context of indirect clearing, when the clearing member is acting as an intermediary between the client and a qualifying CCP; (3) Transactions with intragroup counterparties; (4) Transactions with pension fund counterparties; and (5) Transactions with sovereign counterparties.

48 Commission Staff Working Document: Strengthening the International Role of the Euro (SWD(2019) 600 final) ([link](#)). In its report summarising the outcome of the targeted consultation, the Commission pledged to engage with EU Price Reporting Agencies and commodity exchanges to “explore options for facilitating the emergence of euro-denominated global reference” for natural gas.

**Figure 12: Summary of key regulation applying to energy markets**



## 2.4. Conclusion

This section has explained how and why, following the financial crisis, the physical energy and energy derivatives trading landscape has been brought into financial services regulation. The most relevant changes in the key pieces of legislation are summarised in Figure 12.

Most market participants understand the rationale behind the policy and law makers' objectives and agree that there was a need for reform in most areas. However, for many participants in the energy markets, these new obligations have proved complex and it has taken significant effort and resources to understand how to comply with them and implement new arrangements in their operational, day-to-day practices. The following section of this report looks to assess how this legislative and regulatory change has affected the way business is done in the energy markets and provides reflections on the experience of market participants.



### 3. Regulatory impact in practice

This section seeks to assess the impact of financial services legislation on the energy markets, taking into the account the perspective of market participants active in these markets, as well as implementation experience acquired by exchanges. The analysis looks at aspects of the legislation that have worked well in practice, but also identifies shortcomings of the regulation, with a view to highlighting the areas where there is room for further improvement.

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### 3.1. Proportionality: theory and practice

While European legislators started to address trading in energy markets on a more bespoke basis with the adoption of REMIT, subsequent pieces of legislation primarily designed for the financial markets were applied to energy markets with relatively little tailoring. The need to adapt financial legislation to accommodate the realities of commodity derivatives markets was acknowledged – in its 2009 assessment of derivative markets, the Commission stated that “A significant number of participants in these markets are not financial firms, but commercial producers hedging their price risks. Therefore, legislation designed for the financial sector may not be adequately tailored to their activity and risk profile” and “While regulation aimed at financial players may not be appropriate for commercial firms, various provisions in recently adopted EU energy and emissions market legislation signals the need to converge key

*aspects of the regulation of some physical commodity markets and financial commodity derivative markets*”.<sup>49</sup> However, in practice, while minor adjustments were made to specific pieces of financial services regulation to “address the characteristics of commodity markets”, such efforts did not (with a few exceptions) go as far as to distinguish at a more granular level between various commodity asset classes such as power and gas.

To ensure a comprehensive understanding of how regulation has been implemented in practice, the authors held numerous formal and informal conversations with various energy market participants in both the physical energy and energy derivative trading sector. A survey was also distributed to exchanges and market participants, with the aim of understanding the impact of the key pieces of regulation.

### 3.2. Operational and economic impact

#### a. REMIT

In the context of the broader financial services legislative and regulatory framework that energy markets find themselves in, REMIT often receives positive reviews especially from energy market participants that are not otherwise financial institutions and are more active in the spot than in

derivative markets. When questioned about their experiences with REMIT, numerous market participants consider that the legislation has achieved its objectives. When asked for specific examples, they highlight the fact that the sector-specific character of REMIT has helped to improve transparency in energy markets and the corresponding efforts against market abuse and market manipulation.

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<sup>49</sup> Commission Staff Working Paper accompanying the Commission Communication: Ensuring efficient, safe and sound derivatives markets, 3 July 2009 (SEC(2009) 905 final) ([link](#)). The Commission was referring to, among other, certain provisions of Third Energy Package.

Prior to the introduction of REMIT, the market behaviour of market participants in the physical energy sector was, in some parts of Europe, only governed by antitrust law provisions and only when the market participant enjoyed a dominant market position. As a result, major parts of the market were left without oversight causing public trust in the formation of energy prices to deteriorate. However, even before the implementation of REMIT, power exchanges in some regions of Europe, such as Nordic-Baltic, had established their own market conduct rules. These rules had similar prohibitions on market manipulation and insider trading that were later introduced through REMIT. The implementation of REMIT has helped to restore public trust in the integrity of wholesale energy prices. This is largely thanks to the fact that market participants made efforts to achieve what ACER called a “*compliance regime*”, focused on developing corporate culture and arrangements to comply with REMIT requirements.<sup>50</sup>

There has also been an improvement in the quality of ACER’s guidance since the application of the reporting requirements. At the start of the application, perhaps unsurprisingly for such major reform, there was some confusion among market participants.<sup>51</sup> As ACER itself has identified, the quality of data received as a result of REMIT reporting requirements is not yet perfect with “*detected inconsistencies in reporting [ ] most commonly related, but not limited to, the reporting of orders to trade and their lifecycle events.*”<sup>52</sup> All in all, however, after eight years since its entry into force and nearly five years since the application of its reporting obligations, REMIT is now widely accepted by the markets.

## b. EMIR

The introduction of EMIR provided a taste for energy market participants of what compliance with financial services legislation might mean in practice. For example, to benefit from the flexibilities that have been built into the regime for non-financial institutions, they must spend a considerable amount of effort to work through some complex categorisations and calculations first, and then justify to other market participants that they have done so. Although non-EEA counterparties are not subject to obligations under the legislation themselves, they often need to understand and apply it so that their European bank counterparty can comply. Many energy market participants have to comply with the reporting and some risk mitigation obligations but NFC has been spared the need to clear or exchange margin in accordance with the detailed requirements. To date, no OTC energy derivative contract has been declared subject to the clearing obligation, but market participants have no certainty as to if and when that will change.

Some market participants shared the view acknowledged by the Commission, that “*EMIR may impose in some targeted areas disproportionate costs and burdens and that certain requirements may be simplified to achieve the objective of financial stability more efficiently*”. Some of the most affected sectors include “*derivatives counterparties that are part of the periphery of the derivatives trading network (e.g. small financials, NFCs, pension funds)*”.<sup>53</sup> From the energy markets perspective, however, EMIR also marks some positive developments. While a large part of energy derivative products remain bilateral, broker-traded, non-standardised OTC contracts, the fact that dealing in OTC derivatives now involves quite complex compliance obligations has

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50 See section 10.3 of ACER Guidance on the application of REMIT. Updated 4th Edition (15 October 2019 ) ([link](#))

51 ACER Quarterly issue No. 17 / Q2 2019 ([link](#)).

52 ACER REMIT Quarterly issue No. 17 / Q2 2019 ([link](#)).

53 Commission Staff Working Document – Impact Assessment – Accompanying the document: Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories (SWD(2017) 148 final) (04 May 2017) ([link](#)).

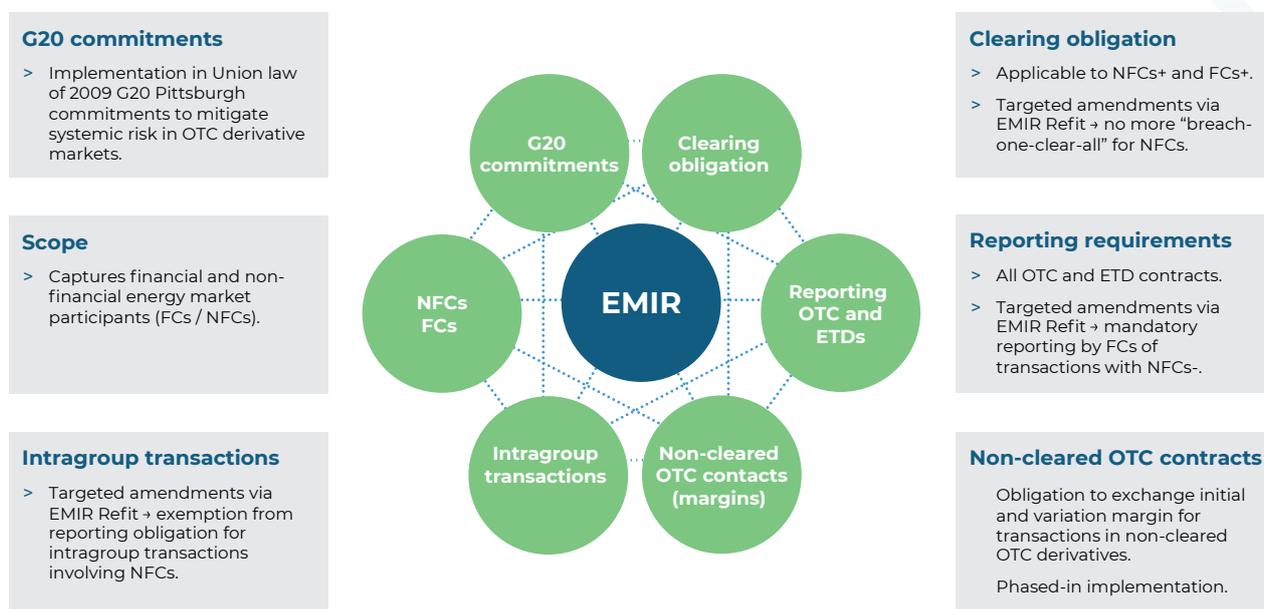
resulted in shifting some of this trading activity onto trading venues. The 2019 figures show record-high volumes of on-exchange trading of gas contracts.<sup>54</sup>

From the perspective of energy market participants, it is particularly important to get the right balance between a comprehensive regime and proportionality as well as capture the right market participants for the relevant obligations in EMIR because of its wide scope. Without this balance, there is a risk that corporates and end users may not use the financial markets to hedge their risks and that non-European entities may prefer to trade with counterparties outside the EEA. This is one of the reasons why the amendments in EMIR Refit targeted counterparties that had experienced a disproportionate compliance bur-

den are broadly considered as positive improvements, particularly in the context of the reporting requirements. This development marks progress on making EMIR more fit-for-purpose for energy market participants.

On the other hand, changes to the requirements do not affect all market participants in the same way and sometimes there are important differences between different parts of the energy markets. For example, the ability to use non-fully collateralised commercial bank guarantees as collateral for CCPs played an important role in the success of clearing in the Nordic energy markets; those markets noticed a flow of trading back to the bilateral markets because of the increased cost of clearing after ESMA's decision to permit their use was discontinued.

**Figure 13: EMIR: Energy markets impact snapshot**



54 European Commission Quarterly Report on European Gas Markets, Market Observatory for Energy, Volume 13 (issue 3, third quarter of 2019) ([link](#)). Data for July-August 2019 demonstrates that “the share of exchange executed contracts” increased by 8% in comparison to the same period in the preceding year and reached 37% of the total volumes of contracts executed (57% being OTC bilateral and 6% OTC cleared). Exchange executed volumes grew even more, demonstrating a 75% increase in year-on-year comparison to the preceding period.

## c. MiFID II

Given its breadth and the scope of its requirements, views about MiFID II are diverse, depending on the issue at stake and the type of industry representative. Some market participants are authorised to carry on their trading activities and have to comply with the full set of requirements. However, many other market participants engage in regulated activities, as they trade in OTC derivatives and/or ETDs but manage to avail of the ancillary activity exemption and avoid the requirements that would otherwise apply to them.

If ending the commodity dealer exemption and amending the ancillary exemption was meant to bring more energy market participants within the scope of authorisation, it is not apparent that this has been achieved. However, the success of the ancillary activity exemption may be more subtle in the sense that it has forced a wider range of energy market participants to consider EU financial services legislation, many for the first time. The annual notification requirement for those relying on the ancillary activity exemption requires such market participants to continue monitoring their trading activities on a regular basis so that they can understand when their activities might approach the need for regulation. Although many market participants found it difficult to apply the complicated threshold tests in the first year, due to both a lack of clarity on which transactions to include and a lack of internal data categorised correctly, this seems to be getting easier in subsequent years. Overall, our impression was that there is genuine gratitude towards the legislators for making the effort to design the exemption with the needs of the industry in mind. This is especially true regarding recognising the role of 'privileged transactions' and tailoring the thresholds per asset class. There is also a realisation that the increased discipline in monitoring trading activity, including by designing and following appropriate hedging policies, can help to create a more robust trading culture and environment within firms. It must also be remembered that some MiFID II provisions, such as those imposing position limits

and requiring position reports, apply to those that are not investment firms in any event.

This perspective on MiFID II may not be quite as positive if one looks past the areas identified in the previous section and focuses on position limits and the hedging exemption. Criticism of the European position limits regime seems to be fairly unified across the board. However, this has been acknowledged by the EU authorities which are being proactive in working with the industry to find a more effective solution.

### **Position limits: one of the most widely applicable MiFID II requirements**

#### **Policy objectives analysis**

The position limits regime for commodity derivatives has been broadly identified by market participants and market infrastructure operators alike as by far the most problematic component of MiFID II that they have to comply with. This might be seen as somewhat ironic given that this is one of the only parts of MiFID II that is tailored to commodity derivatives. However, this demonstrates that it does not always make sense to treat all commodity derivatives the same way.

There are multiple reasons for this – from misalignment between the policy objectives and the actual market impact, through lack of proportionality (in terms of instruments and persons in scope), expansive scope in terms of the contracts impacted, high compliance costs and, last but not least, the resulting impact on competitiveness of the European energy markets from an international perspective.

Starting from the policy angle, there is a feeling broadly shared by market participants that the position limits regime seems to have no (or at best a very limited) role in preventing market abuse in the energy derivatives markets. They do not question the important role of the regulatory framework in preventing market abuse but consider that this is largely achieved through the operation of REMIT and MAR; in accordance with whose strict requirements, operators of trading venues had to adapt their market surveil-

lance and compliance systems. In addition, many operators of regulated energy exchanges already imposed their own position limits (pre-dating MiFID II) where they considered appropriate limits and built surveillance systems and arrangements around them that the market generally agreed worked well in practice. It appears, therefore, that the market considers the monitoring of trading activities and behaviour, rather than sizes of trading positions to be key to efficient monitoring against market abuse. Furthermore, the latter on its own is not an indication of market abuse.

Feedback received for the purpose of this report is consistent with what the industry expressed in the course of ESMA's recent call for evidence. The scepticism of the policy link between position limits and market abuse was expressed by energy market operators, energy trading companies and financial institutions active in commodity markets.<sup>55</sup> ESMA did acknowledge that *"most respondents to the call for evidence were of the view that position limits have no role, or if any, a very limited one, with regard to the prevention of market abuse, noting in particular that a large open position is not per se evidence of market abuse and that market abuse can also be committed with a small open position."*<sup>56</sup> However, rebuffing those views, ESMA stated in its November 2019 MiFID II monitoring report on position limits, that it was *"of the view that position limits can contribute to the prevention of market abuse by limiting the ability of financial counterparties to make use of a dominant position to secure the price of a commodity derivative or of the underlying commodity at an artificial level."* Interestingly though, in its final review report on MiFID II position limits published in April 2020, ESMA concludes that *"beyond the specific risk of a market squeeze and cornering*

*(...), ESMA generally agrees with respondents that position limits on their own have little impact on market integrity (...)"*.<sup>57</sup> ESMA did not significantly change its view on this point, further acknowledging that *"the combination of position and transaction reporting can facilitate the identification of potential abuses"* by NCAs.<sup>58</sup>

### Scope analysis and impact on innovation

The scope of the position limits regime and issues relating to its proportionality are often mentioned by those familiar with energy markets. In particular, when considering the origins of such a broad regime it is noteworthy that no preceding regulatory failure in the energy markets - in terms of excessive price speculation - would seem to have justified such an expansive approach. Also, in absolute numbers and notional values of contracts traded, energy derivatives trail behind other commodity asset classes, notably metals and oil products.<sup>59</sup> That said, position limits have not had a considerable negative impact on the most liquid, "benchmark" contracts.

The situation, however, is quite different when one tries to assess implications of the position limits regime on new and illiquid contracts and the connected issue of market innovation. From both the market participants and energy markets operators' perspective, the impact of the position limits regime on market innovation appears to be one of the core problems. This is particularly relevant in relation to electricity derivative contracts that are considered as fast-growing markets, where the *de minimis position limit* of 2,500 lots for contracts with a combined open interest in spot and other months' interests not exceeding 10,000 lots over three months<sup>60</sup> are considered too restrictive. This, coupled with the lack of a fast and efficient adjustment procedure at the disposal of

55 Joint FIA, ISDA and GFMA response to ESMA Call for Evidence on position limits and position management controls, 05 July 2019 ([link](#)).

56 ESMA Consultation Paper: MiFID II review report on position limits and position management / Draft Technical Advice on weekly position reports (ESMA70-156-1484) (05 November 2019) ([link](#)).

57 Ibid.

58 ESMA MiFID II review report on MiFID II position limits and position management (ESMA70-156-2311) (01 April 2020) ([link](#)).

59 ESMA Opinion On ancillary activity – market size calculation – update for the year 2018 (ESMA70-156-478) ([link](#)).

60 Article 15 Regulation (EU) 2017/591 with regard to regulatory technical standards for the application of position limits to commodity derivatives

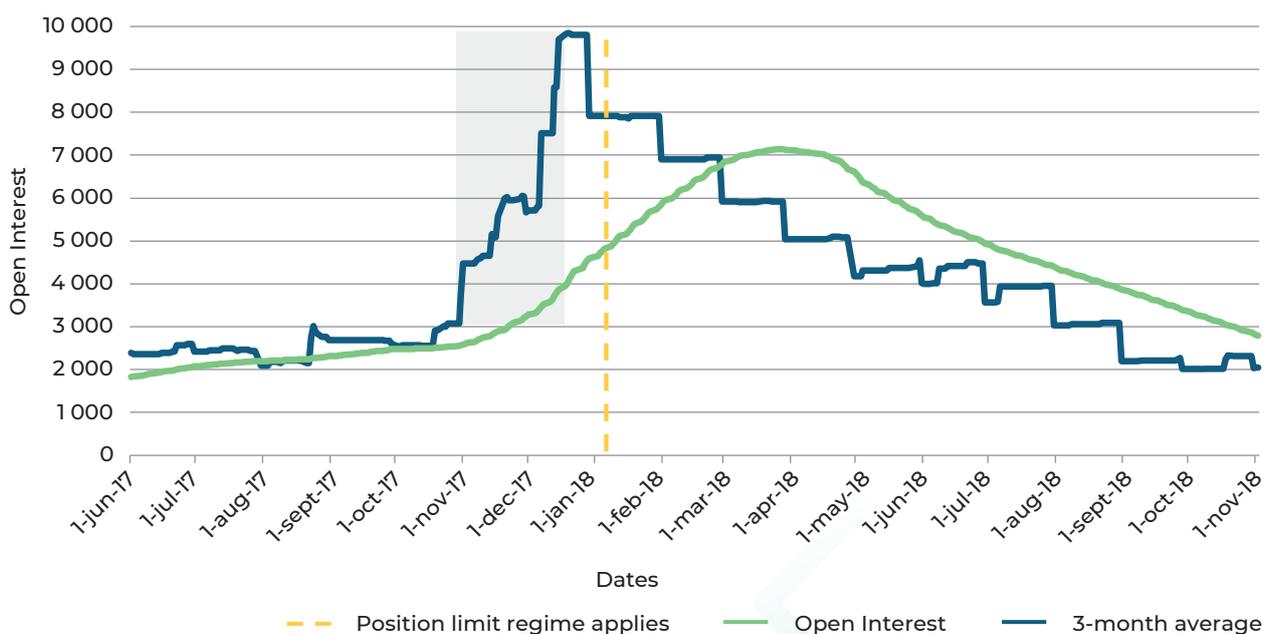
NCA, is perceived to have a freezing effect on trading activity and market innovation. As explained in section 2 of this report, because liquidity begets liquidity, there is a significant challenge for new and illiquid contracts to develop and grow into a “liquid” status. As a result, illiquid contracts have been “sealed” in their illiquid status – which is counterproductive to the policy objectives.

While position limits applied to the most liquid, “benchmark” contracts per asset class, are generally considered to function well, they do constitute an important challenge to the level playing field between a benchmark contract and competing liquid contracts with the same physical underlying and same characteristics traded at different exchanges. Growing liquidity in these competing non-benchmark contracts has proven difficult and is often due to much higher position limits set in “other months” for the benchmark contracts than for the second or third most liquid contracts at competing exchanges. When position limits are

materially different, there is a risk that traders and market makers will seek to trade on the most liquid market only; in other words, where they have a lower risk of breaching the position limit.

This issue was addressed by ESMA in its consultation paper on the MiFID II review report on position limits and position management in commodity derivatives. The most liquid market with the highest open interest benefits from the highest position limit, pushing the liquidity to the largest exchange hosting the “benchmark contracts” or the so-called “critical contract” as referred to in the consultation. ESMA suggested an alternative solution where position limits of the most liquid commodity derivatives contracts should be applied to competing contracts that are deemed liquid and have the same physical underlying. The intention is to prevent any discrimination of the MiFID II position limit regime towards trading venues with lower open interest in a contract with the same physical underlying.

**Figure 14: Impact of position limit regime on development of ICE Endex Italian PSV Gas Futures market<sup>61</sup>**



61 Europex Report: Position limits and position management in commodity derivatives ([link](#)).

Section 4 of this report provides an international comparison of the European legislative and regulatory framework, but it is worthwhile to note that the scope of the MiFID II position limits regime exceeds all comparable third-country regimes. While it is impossible to obtain hard data demonstrating how many market participants may have switched as a result of the operation of the MiFID II regime to trading in other jurisdictions, anecdotal evidence suggests that this has happened and continues to do so.

### **Public authorities (initial) response**

Finally, this section would not be complete without taking further note of what public authorities have already started doing in respect of potential changes to the MiFID II position limits regime.

At the time of writing this report, ESMA recently completed a public consultation on the operation of MiFID II position limits and position management controls. Through this consultation, ESMA sought stakeholder views on prospective changes to the scope of the regime<sup>62</sup>. ESMA considered two options to reduce the scope of contracts subject to limits to address stakeholder concerns about the impact of the regime on new and illiquid contracts. The first option is to reduce the scope of the regime to a limited set of significant or critical contracts. The second is to amend the relevant legislative provisions in a way that would allow ESMA to develop specific Level 2 measures with regard to new commodity derivatives and determine when position limits should start applying to those contracts.

Encouraging supporters of a more targeted approach to the application of position limits, ESMA noted that *“a more limited scope of commodity derivatives subject to position limits will also have the benefit of addressing the concerns expressed by stakeholders with regard to the impact of position limits on new and illiquid contracts.”* They further point out that such a targeted approach will bring the EU regime closer to the US one, where the federal position limits regime applies *“only to a limited set of nine agricultural contracts, with consideration being given by the CFTC to a potential extension of position limits to an additional set of 16 agricultural, oil and metal contracts”*. This has been one of the key points raised by the European industry during the legislative review of MiFID II; as such, it is encouraging to see this consideration being picked up by ESMA.

Finally, it is important to note that in terms of initial industry response to ESMA proposals, European energy exchanges strongly support the option that would limit the application of the position limits regime to the core set of ‘critical’ contracts. Only in respect of such contracts might the size of individual positions be sufficiently significant to influence the price of relevant commodity derivative contracts.<sup>63</sup> Limiting the scope of the position limits regime to ‘critical’ contracts would not leave the markets exposed to potential adverse activity as ‘non-critical’ energy derivative contracts will continue to be subject to position management controls and rigorous trading activity surveillance by operators of regulated energy exchanges. The views of energy exchange operators are, to this end, fairly consistent with those expressed by financial services lobby groups.<sup>64</sup>

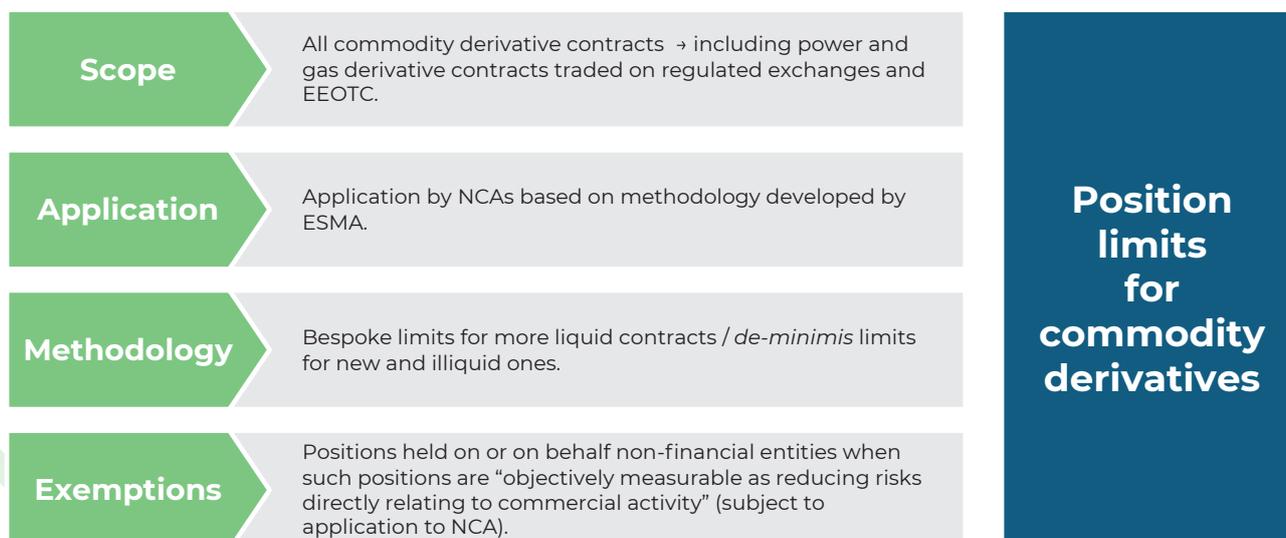
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62 ESMA Consultation Paper MiFID II review report on position limits and position management Draft Technical Advice on weekly position reports (ESMA70-156-1484) ([link](#)).

63 Europex response to ESMA consultation paper on MiFID II review report on position limits and position management, 06 January 2020 ([link](#))

64 Joint FIA and ISDA response to ESMA Consultation on Position Limits under MiFID II, 08 January 2020 ([link](#))

**Figure 15: Position limits: Energy markets impact snapshot**



### Hedging exemption for position limits

Recognition under the MiFID II regime given for transactions and positions in derivatives that are “objectively measurable as reducing risks directly relating to the commercial activity” of the participant or its group (the ‘hedging exemption’) has been welcomed by energy derivatives market participants. Thanks to this exemption, corporates with hedging needs can continue to access energy derivatives markets as part of their risk management strategies. As it stands, however, this exemption is currently only available to non-financial entities, whether in the context of the ancillary activity threshold calculations, or in terms of the exemption from the application of position limits or the pre-trade transparency regime.

Market participants have praised the existence of the hedging exemption from the position limits regime but also point to some of its perceived shortcomings. These shortcomings are linked with procedural requirements rather than any substantive issues, particularly issues associated with the application for such exemption. One common theme is the lack of harmonisation across Member States, with various NCAs having

adopted different procedures and/or approaches to implementation of the hedging exemption (including the application of quantitative limits to the hedging exemption).

Another issue is the limitation of the application of the hedging exemption to non-financial entities only. However, as practice demonstrates, energy derivative markets cannot be viewed in isolation from their financial participants and this opportunity for interplay that the exchanges provide is one of their key benefits. While the majority of liquidity in power and gas derivative markets continues to be provided by major, non-financial market participants, financial institutions remain important clients – more so, when one considers some of the additional challenges that energy markets (notably the transition to a climate-neutral economy) are facing. Without this liquidity, access to hedging instruments by smaller, non-financial entities would be much more restricted. The initial response from public authorities towards a possible amendment to the hedging exemptions was balanced. The BMF has recognised the problem of the hedging exemption in the context of position limits and included it on the list of sug-

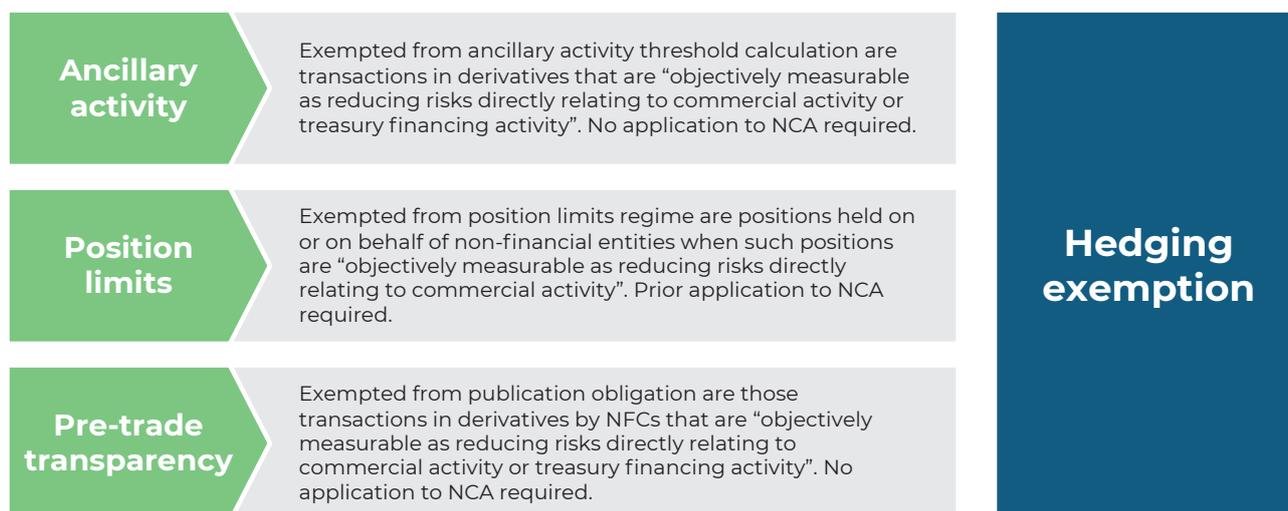
gestions for “medium-term” amendments where more in-depth assessment may be required.<sup>65</sup>

Separate from the hedging question, ESMA considered the possibility of expanding the application of the hedging exemption from the position limits regime (albeit in a limited manner) to certain financial entities. ESMA treaded carefully though and noted in their consultation paper that it “could see merits in introducing a position limit exemption in Level 1 for “mandatory” liquidity provision”<sup>66</sup>. they also considered an alternative

exemption for financial counterparties “within a predominantly commercial group” where the financial entity acts as the market facing entity for the group.<sup>67</sup>

The industry response to ESMA’s considerations regarding a possible extension of the hedging exemption to financial entities was positive. This view was largely expressed by operators of the energy exchanges, as well as other regulated markets, financial institutions and energy trading companies.

**Figure 16: Hedging exemption: energy markets impact snapshot**

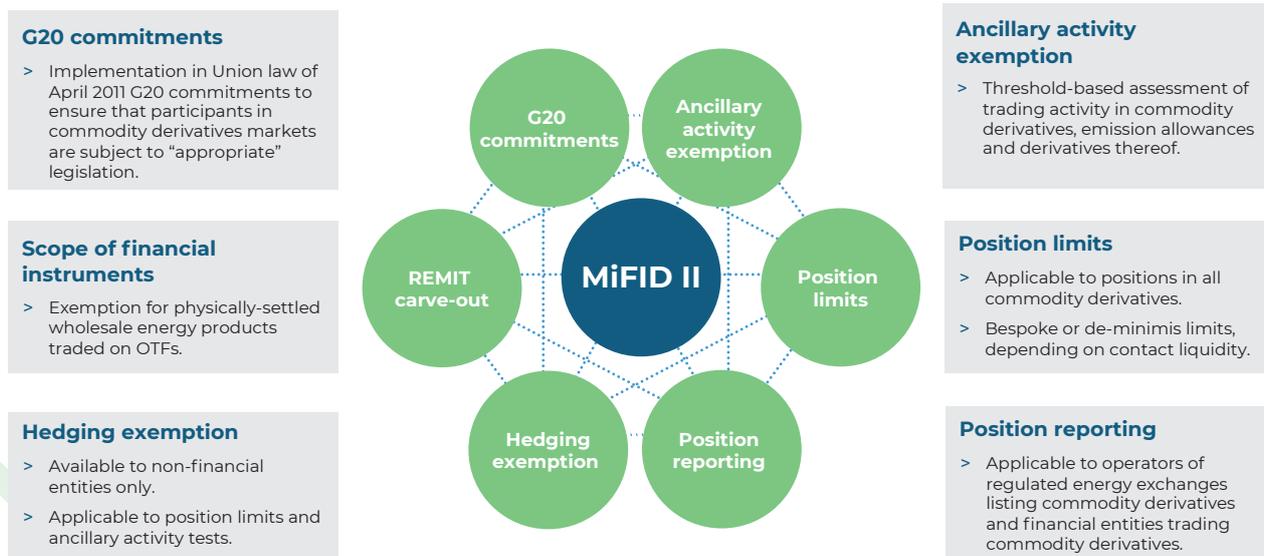


65 BMF Position Paper: “Commodity derivatives: The application of MiFID/MiFIR core requirements to commodity derivatives raises a number of questions that should be analysed more closely: (...) Hedging exemption: Suitability of the scope of application of the hedging exemption from position limits (...)”.

66 ESMA Consultation Paper: MiFID II review report on position limits and position management: Draft Technical Advice on weekly position reports, page 27.

67 ESMA Consultation Paper: MiFID II review report on position limits and position management: Draft Technical Advice on weekly position reports, page 18

**Figure 17: MiFID II: Energy markets impact snapshot**



#### d. MiFIR

The impact of MiFIR on commodity derivatives market participants and energy markets is assessed mainly through MiFIR’s provisions on pre-trade transparency. While market participants and energy exchange operators strongly support transparency in the power and gas derivatives markets, the practicalities of certain aspects of the current regime have proven challenging to comply with.

##### **Pre-trade transparency for energy derivatives**

When discussing the application of the pre-trade transparency regime for the energy markets, the response is often “*too early to tell*”. They do, nonetheless, warrant their place in this report given the already identified prospective problems with the application of the regime. Again, the comments we have encountered broadly span issues such as the regime falling short of policy objectives, costs of compliance, and particular issues linked with the calibration of Large in Scale (LIS) and illiquid (IL) waiver thresholds and liquidity criteria.

Taking these points in order, the policy objective argument focuses on the regime’s lack of recognition of the energy market’s characteristics. This is demonstrated by the fact that the Commission only attempted to deal with the application of the pre-trade transparency regime to pre-arranged (negotiated) transactions in the aftermath of MiFIR’s adoption. These types of transaction are prevalent in energy derivatives trading and important to transforming what would otherwise be OTC contracts into regulated exchange contracts. Uncertainty about how waivers would work in respect of these trades could undermine the policy objective of encouraging appropriate transactions onto exchanges.

Costs of implementation are a cause of concern amongst market participants across requirements, but the operators of exchanges believe the bulk of spend in relation to pre-trade transparency rests with them.

In terms of technical elements of the operation of the pre-trade transparency regime for energy derivatives, a number of major flaws have been iden-

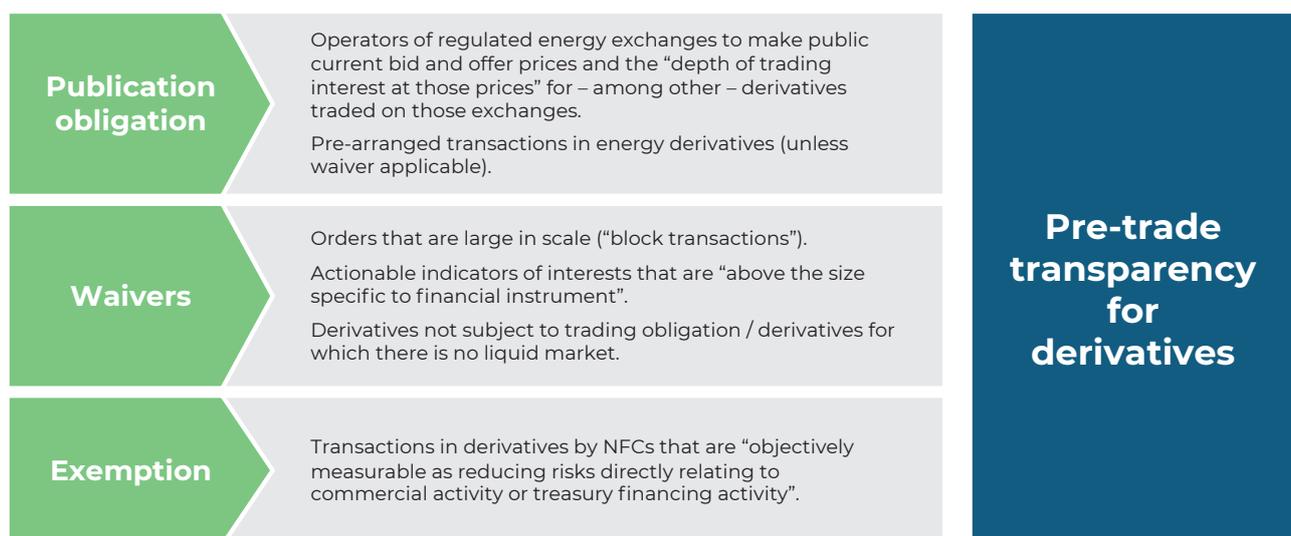
tified<sup>68</sup>. By way of example, one of these is the LIS threshold calculation, which is the threshold of volume, above which bids and offers do not have to be made public, assuming the exchange has obtained a waiver from the pre-trade transparency obligations. The LIS threshold is problematic both from a structural point of view (the methodology for energy derivatives mirroring the solution for equity markets) but also the operational perspective (relying on outdated data). The energy industry considers the LIS threshold of EUR 500,000 as far too disconnected with market reality and has suggested that EUR 50,000 would be more appropriate. It is worth noting that as an interim measure, energy exchanges did call for the establishment of a methodology to convert LIS notional values to lots.<sup>69</sup>

The root of the problem appears to lie with the underlying methodology that does not allow for a sufficiently granular approach. In the debate of what should constitute the basis for pre-trade transparency threshold calculations for deriva-

tives, the Class of Financial Instruments Approach prevailed over the Instrument By Instrument Approach.<sup>70</sup> Having developed both approaches, ESMA concluded in favour of COFIA arguing that it “will provide the market participants with stability and predictability in respect of the transparency rules that apply to non-equity instruments” and that it is “much less complex than IBIA and will be less of an administrative burden for industry and authorities alike”.<sup>71</sup> While there may be some merit in the second argument, the “stability and predictability” referred to in the first one did not appear to outweigh the perceived calibration errors.

Again, the consequence of inappropriate thresholds for the exemptions from pre-trade transparency is significant for the energy markets. This is because they either disincentivise market participants from trading on organised trading venues where the calculation results in too high a figure or, conversely, allow for trading without publication of transparency data where it might not be appropriate if the calculation comes out too low.

**Figure 18: Pre-trade transparency: Energy markets impact snapshot**



68 Europex Position Paper: MiFIR Pre-Trade Transparency Regime: Making it Work for Commodity Derivatives (25 June 2018) ([link](#)).

69 Europex Position Paper: MiFIR Pre-Trade Transparency – Call for a Methodology for the Conversion of LIS Notional Values to Lots (15 July 2019) ([link](#)).

70 In COFIA approach, liquidity status of an instrument is set out in MiFIR secondary legislation. Under the IBIA approach, liquidity of instruments would be assessed on frequent and recurrent basis, using pre-defined set of criteria.

71 ESMA Consultation Paper MiFID II / MiFIR (19 December 2014) ([link](#)).

## e. Reporting

Finally, to conclude this market impact analysis, it is worthwhile to address the regulatory reporting requirements as discussed under section 2 of this report. Many market participants have spent considerable time and money to operationalise their reporting obligations under the pieces of legislation that apply to them. Unfortunately, many feel they run considerable risk of inadvertently reporting incorrectly because of a misinterpretation of the requirements or operational failure in the process, which often involves third parties.

Calls for “streamlining of the requirements” have been repeatedly put forward during multiple rounds of public consultation undertaken by the European Commission in the course of its fitness check of supervisory reporting in financial services launched in 2015. It is perhaps, therefore, no wonder that the result of that fitness check reported by the Commission in November 2019 found that *“EU level supervisory reporting requirements are broadly effective, highly relevant and bring the EU added value”* was met with some surprise. The review did, however, conclude that *“there is scope for simplifying and streamlining EU level supervisory reporting, helping to reduce the cost and*

*burden of supervisory reporting at EU level for all stakeholders and further improving the quality of data available to the supervisory authorities”*. If and how this will be transposed into specific policy action is yet to be confirmed and is subject to further assessment.

However, there are mixed views in the energy and other markets as to whether it would be helpful to streamline the reporting obligations at this stage, long after the resources have been spent implementing the original requirements and various amendments. While the design of reporting requirements across various pieces of legislation may not be praised by the market participants, the biggest concern would be to see small, albeit well intentioned, tweaks to the regimes. Many fear that they would be unlikely to lead to such comprehensive “streamlining” of reporting requirements as is desired and instead create additional compliance obligations and cost. If, on the other hand, it were possible to streamline the regime such that for any one transaction, order, transaction and position data could be submitted to a single entity and be accessed by all relevant authorities, this solution would be welcomed.

## 3.3. Conclusion

In this section 3 we focused on the main practical changes that post-2008 financial services regulation brought to the energy markets, their participants and their clients. As discussed, these changes were profound and not without implications for the execution of their day-to-day business. Certain elements of the MiFID II / MiFIR framework appear to be particularly problematic, due to poorly calibrated methodologies that are not suitable for the energy markets in scope. The most notable example is the MiFID II position limit regime which was considered to hamper growth in new and illiquid markets as well as a lack of level playing field between exchanges offering liquid contracts based on the same physical underlying. The MiFID pre-trade transparency regime was also identified as problematic – key issues were the relatively high cost of compliance when compared to the benefits sought by policy and poorly calibrated waiver thresholds which risk disincentivising market participants from trading on organised trading venues.





4.  
Comparison of  
the EU regulatory  
landscape with other  
international jurisdictions

In this section we consider three G20 jurisdictions (US, Singapore and Switzerland) which are important commodity derivative trading hubs outside the EU which have relatively comparable, sophisticated legal systems and regulatory regimes. The aim of this analysis is to compare how certain aspects of commodity derivative regulation are dealt with, identify any best practices or innovative approaches and understand how the different approaches can affect competition at a global level.

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## 4.1. IOSCO principles and G20 commitments

### International framework

Before we jump into the specifics of each jurisdiction and their policies, it is important to consider the international framework within which these objectives were set. In the aftermath of the financial crisis, the G20 made commitments at the 2009 Pittsburgh Summit to increase transparency and market operation. These commitments not only included the statements on OTC derivatives discussed in relation to EMIR in Section 2, but also energy specific policies. The G20 proposed that energy markets implement the IOSCO recommendations on commodity futures markets to improve oversight; they also suggested steps to combat market manipulation leading to excessive price volatility and improvements in commodity market information.

At the G20 Summit in Cannes in November 2011, the G20 endorsed the final report on the resulting IOSCO Principles<sup>72</sup>. The Principles aim to ensure that the commodity derivatives markets serve their fundamental price discovery and hedging functions, while operating free from manipulation and abusive trading schemes.<sup>73</sup> In their declaration, the G20 stipulated that market authorities should have the ability to use formal position management powers where appropriate. This included the power to set ex-ante position limits,

particularly in the delivery month, and re-affirmed their commitment to enhance transparency and avoid abuse in commodity markets, including OTC markets.<sup>74</sup>

On 19 November 2018, IOSCO published the final report on its survey review of the implementation of the IOSCO Principles and updates on international developments surrounding them. This report marked the third implementation review of the Principles since 2011 and shows many jurisdictions have made progress towards achieving full compliance.

### Implementation of the G20 commitments and IOSCO Principles in the EU

Since the IOSCO Principles were published in 2011, a number of reform initiatives have been implemented globally. In the EU, the implementation of MiFID II and MiFIR established the pre-and post-trade transparency requirements, position limits and position reporting requirements for commodity derivatives. MAR and the independently developed REMIT further strengthened compliance with the Principles related to the surveillance framework and use of market information.<sup>75</sup>

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72 IOSCO final report: (link).

73 Page 11, Principles for the Regulation and Supervision of Commodity Derivatives Markets.

74 Page 1, Update to Survey on the Principles for the Regulation and Supervision of Commodity Derivatives Markets.

75 Page 4, Update to Survey on the Principles for the Regulation and Supervision of Commodity Derivatives Markets.

## Jurisdictional comparison

We have considered three G20 jurisdictions which are important commodity derivative trading hubs outside the EU and have comparable, sophisticated legal systems and regulatory regimes. In this section we examine the United States of America, Singapore and Switzerland - although the UK might constitute a fourth jurisdiction that satisfies these criteria. However, because its regime is still so similar to that of the EU, we have elected to focus on the aforementioned three countries. In each jurisdiction we have determined how they address the key issues of position limits, including any carve-out from the position limit regime or other obligations for counterparties that use commodity derivatives to hedge risk and pre-trade transparency in relation to energy derivatives. However, any comparison needs to clarify which types of contracts these obligations relate to before drawing any conclusions. As such, we have also sought to summarise the scope of the regime before considering how it compares to the EU.

The EU currently enjoys being home to many commodity derivative trading firms and markets, but there is no guarantee that this business will

continue in the EU, either for EU based organisations or those based in third countries. The differences in scope and approach to implementation between countries are critically important as regulatory barriers can deter participants from establishing (or keeping) their business in a particular region. Many of the international standards that key jurisdictions are implementing are indeed aimed at uniform application, but such coordination can cause even small variations in regimes to present a major difference. This undermines the level playing field and allows those participants to choose between the markets and countries that best suit them. Regulatory arbitrage is a fact that EU policy makers should be concerned about to keep the EU competitive. Other jurisdictions have implemented the IOSCO Principles and G20 commitments in a way that provides for greater flexibility by taking into account the specific role of the energy markets and the interface between energy and financial markets. Compared to other jurisdictions, the current EU regime has adopted a stricter approach in some areas (for example in relation to the current EU position limits regime); by not taking into account the specific nature of these markets, this approach has effectively created a competitive disadvantage.

## 4.2. United States

The US market is the world's leading energy marketplace for various commodities such as gas oil, crude and refined contracts, as well as a variety of soft commodities. In the aftermath of the 2008 financial crisis, the Dodd-Frank Act was the US policy response to restore public confidence and to promote market integrity, while keeping to its G20 commitments. Title VII of the Dodd-Frank Act includes the regulatory framework for swaps, mandatory clearing, reporting, margin rules for non-cleared swaps, exchange trading and provisions for position limits. The Dodd-Frank Act splits the regulatory jurisdiction over swaps between

the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). The CFTC is generally charged with regulating non-security-based swaps, while the SEC is responsible for security-based swaps.

### Scope of financial instruments

As noted above, certain requirements of the US regime depend on whether a contract is a swap. The term "swap"<sup>76</sup> is broadly defined and contains, for example, interest rate swaps, currency swaps, commodity swaps, options based on interest or

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<sup>76</sup> Section 721(a) of the Dodd-Frank Act defines the term "swap" by adding Section 1a(47) to the CEA (7 U.S.C. § 1a(47)).

a currency exchange rate or commodities. Exchange-traded commodity futures and options on exchange-traded commodity futures are excluded or exempt from the above swap definition under Title VII of the Dodd-Frank Act. The swap definition further excludes from its scope “any sale of non-financial commodity or security

for deferred shipment or delivery, so long as the transaction is intended to be physically settled”.<sup>77</sup> Swaps relating to commodities are also treated as financial instruments in the EU regime, at least where they are or can be cash settled, and are traded on a trading venue or otherwise have financial characteristics.

### What about physically settled commodity options?

The CFTC issued Frequently Asked Questions<sup>78</sup> clarifying that commodity options will generally be regulated as swaps under Title VII of the Dodd-Frank Act. However, certain types of physically settled commodity options may fall outside the scope of Title VII. Commodity trade options fall outside the scope of the Title VII rules specifically if the trade option, which must involve a physical commodity, is offered by an eligible contract or commercial participant (including producers, processors and commercial end users) to a commercial participant and is intended to be physically settled.

The position limits regime in the US has been subject to various changes and amendments for almost a decade, the most recent of which was published by the CFTC in February 2020.<sup>79</sup> The CFTC may impose limits on the amount of speculative trading that may be done or speculative positions that may be held in contracts for future delivery.

Most physical delivery and many financial futures and option contracts are subject to speculative position limits. The CFTC has determined federal limits for the following nine agricultural commodities: corn, oats, wheat, soybeans, soybean oil, soybean meal, and cotton.<sup>80</sup>

### Federal position limits: the key components

1. The level of limits, which set a threshold that restricts the number of speculative positions that a person may hold in the spot month, an individual month, and the all combined month<sup>81</sup>;
2. Exemptions for positions that constitute bona fide hedging transactions and certain other types of transactions<sup>82</sup>; and
3. Rules to determine which accounts and positions a person must aggregate for the purpose of determining compliance with the position limits.<sup>83</sup>

<sup>77</sup> 7 U.S.C. § 1a(47), B (ii).

<sup>78</sup> CFTC Frequently Asked Questions: [\(link\)](#).

<sup>79</sup> Commodity Futures Trading Commission: Position Limits for Derivatives – Proposed Rule (27 February 2020) [\(link\)](#)

<sup>80</sup> 17 CFR §150.2.

<sup>81</sup> 17 CFR §150.2.

<sup>82</sup> 17 CFR §150.3.

<sup>83</sup> 17 CFR §150.4.

Under the US system, the exchanges determine limits for all other asset classes.<sup>84</sup> Conversely, under the current EU position limits regime, ESMA sets the methodology for determining position limits for all contract types and the NCAs are obliged to impose limits on each of them. The US position limits regime therefore benefits from greater flexibility and is not as static as the current EU regime. In particular, the US regime benefits from the expertise of the exchanges. Exchanges have extensive, direct experience overseeing position limits and position accountability levels. However, various attempts by the CFTC to impose position limits have been challenged in the US.

The CFTC is currently revisiting the position limit rules with a view to extending the regime to cover 25 physical commodity derivatives as well as physically settled, linked cash-settled futures, options on futures, and economically equivalent swaps for such commodities. Under the new proposal the spot position limits would apply to the 25 most liquid, physically settled commodity futures including five metals, four energy, and seven agricultural futures in addition to the nine current agricultural futures. Furthermore, the proposal includes certain exemptions from position limits such as a revised definition of “*bona fide hedging transactions or positions*” and an expanded list of enumerated bona fide hedges to cover additional hedging practices. In particular, the proposed changes would allow exchanges to issue exemptions without CFTC approval for trades that fall under the CFTC’s definition of “enumerated hedge transactions.” At the time of writing, this issue was open for public comment for 90 days, ending on 29 April 2020.

## Hedging exemption

Exchanges may grant exemptions from position limits for bona fide hedging transactions. A hedge is a derivative that represents a substitute for transactions to be taken at a later time in a physical

marketing channel. Hedges must reduce risk for a commercial enterprise and must arise from a change in the value of the hedger’s (current or anticipated) assets or liabilities.

CFTC regulation requires that “...no transactions or position will be classified as bona fide hedging...unless their purpose is to offset price risks incidental to commercial cash or spot operations and such positions are established and liquidated in an orderly manner in accordance with sound commercial practices...”<sup>85</sup>

Exchanges may also grant exemptions for “spreads, straddles, arbitrage positions”, or other positions consistent with the purposes of position limit rules and should establish a program for traders to apply for these exemptions.<sup>86</sup>

If granted, an exemption level is set at an amount higher than the speculative limit so as not to give a limitless hedge exemption. Exchanges sometimes disallow hedge exemptions or place restrictions on exemptions during the last several days of trading in a delivery month. The CFTC periodically reviews how each exchange grants exemptions, how it monitors compliance with its limits and what types of regulatory action (warnings, fines, trading suspensions, etc.) the exchange takes once a violation of a position limit or exemption is detected.

## Pre-trade transparency

A main goal of the Dodd-Frank Act is to bring greater pre-trade transparency to the swaps market, while the aim of the pre-trade transparency regime is to lower costs for investors, consumers and businesses. The pre-trade transparency requirements apply to Designated Contract Markets (DCM) and Swap Execution Facilities (SEF) meaning that bid and offer prices, quantity and other relevant information must be made available to the market before a swap is executed.

84 Since the Commodity Futures Modernization Act of 2000, amended the CEA in 2000, the CFTC has retained 17 CFR § 150.5, but only as guidance on, and acceptable practice for, compliance with core principle 5; see 17 CFR § 38.300.

85 17 CFR § 1.3.

86 17 CFR § 150.5(a).

Pre-arranged trading<sup>87</sup> is expressly prohibited on SEFs, with an exemption for block trades<sup>88</sup> which are currently permitted under the no-action letter until 15 November 2020.<sup>89</sup> However, the relief is subject to various conditions<sup>90</sup> and the market would prefer a permanent solution rather than an extension, but this would require repealing legislation. No-action relief is tailored to each exchange individually, although it is sometimes relied on by the industry at large.

There are also exemptions for exchanges for physical swaps and options. They are regulated by the exchanges, which exercise their discretion under CFTC oversight. The CFTC voted to propose amendments to the rules applicable to SEFs which would make some changes to the mandatory trading requirement. The final rules are still pending.

### Lessons learned

The US position limits regime benefits from greater flexibility and is not as static as the current EU regime due to the added value from the expertise of the exchanges. Exchanges have extensive, direct experience overseeing position limits and position accountability levels, particularly in relation to granting and administering hedging exemptions. This approach shines a light on some of the advantages of the US system, specifically as it concerns granting hedging exemptions. The ability of exchanges in the US to grant hedging exemptions has allowed exchanges to respond more precisely and efficiently to changes. At the same time, regulators have benefited from the practical knowledge of exchanges and can occupy a more supervisory position that enables them to react to any violations as they occur.

## 4.3. Singapore

Singapore plays a key role as a commodity trading hub for Asia, particularly for oil, gas, agricultural commodities, metals and minerals. In 2017 the sector generated close to 1.2 trillion USD in turnover, contributed over 28 billion USD in local business spending and hired about 15,300 professionals.<sup>91</sup>

The Commodity Trading Act (CTA), the Securities and Futures Act (SFA) and the Financial Advisers Act (FAA), all contain legislation relevant to commodity trading, derivatives trading or advisory

services in respect of OTC commodity derivatives and/or commodity futures contracts.

Much like the US and EU, the Monetary Authority of Singapore (MAS) made commitments to the G20 and the Financial Stability Board to reform the way in which OTC derivatives are regulated. To this end, recent reforms aim to align the regulatory requirements for the trading of OTC derivative contracts more closely to the regulatory regimes in the US and the EU. The new Securities and Fu-

87 The CFTC Glossary defines “pre-arranged trading” as trading between brokers in accordance with an expressed or implied agreement or understanding, which is a violation of the CEA and CFTC regulations.

88 17 CFR §37.203.

89 17 CFR § 43.2 defines a “block trade” as, among other things, a publicly reportable swap transaction that “occurs away from the registered SEF’s or DCM trading system or platform and is executed pursuant to the registered SEF’s or DCM’s rules and procedures.

90 Relief is subject to the following conditions: (i) the block trade is not executed on the SEF’s Order Book functionality; (ii) the SEF adopts rules pertaining to cleared blocks that indicate that the SEF is relying on relief in the no-action letter and that require each cleared block trade executed on a non-Order Book trading system or platform to comply with the other requirements in the block trade definition in CFTC regulation; (iii) the futures commission merchant completes the pre-execution credit check at the time the order for a block trade enters the SEF’s non-Order Book trading system or platform; and (iv) the block trade is subject to void ab initio requirements where the swap is rejected on the basis of credit.

91 Media release dated 17 May 2018, ministry of Communication and Information Singapore. Available at: [\(link\)](#).

tures (Trading of Derivatives Contracts) Regulations 2019 (SFA 2019 Regulations) will apply to certain OTC derivative contracts executed on or after 1 April 2020 and introduce a mandatory trading obligation. This is a further step towards the implementation of the G20 OTC derivatives reform,<sup>92</sup> but will also increase the regulatory burden for market participants operating in this market. Under the current regulations, only fixed-to-floating interest rate swap contracts will be subject to the trading obligation and therefore are not directly relevant to commodity derivatives.

## Scope of financial instruments

The definition of “derivative contract”<sup>93</sup> covers any contract or arrangement under which a party is required, or may be required, to discharge any or all of its obligations at some future time, and whose value is determined by reference to, is derived from, or varies by reference to, the value or amount of, or fluctuations in, one or more underlying things.

### Definition of derivative contract: what is excluded?

The definition expressly excludes securities and spot contracts<sup>94</sup> as well as physically settled commodity forwards that have the purpose of fulfilling the day-to-day operations of the business. Those contracts will not be subject to the regulatory regime and reporting obligation. The MAS has clarified that contracts entered into for the purpose of hedging financial risks do not fall within the scope of such exclusions. Apart from this, OTC commodity derivatives contracts are also out of scope because the underlying is intangible.

## Position limits

Conceptually, the position limits regime is similar to the US regime in the sense that the position limits in relation to ETD contracts are set and administered by the exchanges. The exchange can set the position limits by applying its own methodology - an approach that has shown signs of practical success in both regimes. The position limits can be challenged by the MAS which has also issued directions requiring futures exchanges (exchanges that operate an organised market on which futures contracts are listed or permitted for trading) to comply with when setting position limits. Approved exchanges and recognised market operators are required to comply with requirements defined by MAS regulations; these regulations re-

late to the limits that exchanges must establish on the number of open positions that may be held by any participant in respect of the relevant product.<sup>95</sup> The approved exchange must take steps to ensure compliance with the limits established and that the position limits calculated by the approved exchange do not exceed the regulation limits.<sup>96</sup> The limits apply to the participants of the relevant organised market where a participant is defined as any person who may participate in one or more services provided by an approved exchange or recognised market operator.<sup>97</sup>

92 On 13 March 2019 MAS and the CFTC furthermore issued a joint statement announcing the mutual recognition of certain derivatives trading venues in Singapore and the US. Furthermore, on 20 February 2019 the MAS and the EU published an announcement of their intention to adopt a common approach on certain derivatives trading venues.

93 Section 2(1) of the SFA (as amended by the Securities and Futures (Amendment) Act 2017).

94 The definition of “financial instrument” in Section 2 (1) of the SFA does not include derivative contracts.

95 Sections 29 and 41 of the SFA (as amended by the Securities and Futures (Amendment) Act 2017).

96 Please see MAS Notice SFA 02-N01 Listing, De-Listing or Trading of Relevant Products on an Organised Market of an Approved Exchange or a Recognised Market Operator Incorporated in Singapore, a copy of which can be accessed via this link - <https://www.mas.gov.sg/regulation/notices/notice-sfa-02-n01>.

97 Section 2(1) SFA (as amended by the Securities and Futures (Amendment) Act 2017).

## Hedging exemption

The regulatory regime in Singapore does not contain a hedging exemption similar to the hedging exemption under MiFID II in the EU. As set out above, companies that trade derivatives for their own day-to-day operations and where the relevant contracts envisage physical delivery of the underlying commodities are not considered derivatives contracts and are out of scope of the regulations.

## Pre-trade transparency

There is no statutory pre-trade transparency regime, however the Singapore Exchange Futures Trading Rules provide that members of the exchange or approved traders shall not make any purchase or sale which has been pre-arranged except in limited circumstances. The MAS has put in

place a regime for the mandatory trading of specified OTC derivatives on organised markets. One perceived advantage of this step is an increase in transparency.

Under the Securities and Futures (Trading of Derivatives Contracts) Regulations 2019, there is no exemption for block trades. This is because the MAS' trading obligations do not require specific execution methods. Thus, existing execution methods for block trades are not precluded and the trading obligation would be fulfilled so long as the block trades are executed on an organised market. However, the Singapore Exchange Futures Trading Rules provide that members of the exchange or approved traders shall not make any purchase or sale which has been pre-arranged except in limited circumstances.<sup>98</sup>

### Lessons learned

Conceptually the position limits regime is comparable to the US regime in the sense that position limits in relation to ETD contracts are set and administered by the exchanges. Though this approach has shown positive results, elucidating similar benefits to that of the US regime, any comparisons with the EU regime should be done with a caveat. The lack of hedging exemptions and a pre-trade transparency regime means that any lessons to be learned from Singapore are primarily restricted to their position limits regime.

## 4.4. Switzerland

Switzerland is among the largest trading hubs for oil and petroleum, metals (such as iron, copper and gold), minerals and agricultural products (soft commodities).<sup>99</sup> It is home to many commodity-trading groups and plays an important role in global commodities trading.<sup>100</sup> Most of the commodities-trading companies in Switzerland are lo-

cated in the Geneva and Lausanne regions, Zug, and Lugano.

Companies active in commodity derivatives trading are subject to the Swiss Financial Market Infrastructure Act (FinMIA).<sup>101</sup> The result of Switzerland's G20 commitments, FinMIA is the

98 The exemptions are: (i) an exchange of underlying for futures contracts as contemplated under the Futures Trading Rules; or (ii) a negotiated large trade (defined as large trades or specific underlying executed outside of the trading system between and among accredited investors and members pursuant to the minimum thresholds and other procedures prescribed by the Singapore Exchange) as contemplated under the Futures Trading Rules.

99 Council Federal Report, The Swiss commodities sector: current situation and outlook, page 12.

100 Jungbluth N./ Meli C. (2018): "pilot-report for the analysis of environmental impacts of commodities traded in Switzerland", ESU-services Ltd, page 21.

101 The FinMIA entered into force on 1 January 2016 and is supplemented by the two ordinances, the Financial Market Infrastructure Ordinance and the FINMA's Financial Market Infrastructure Ordinance.

Swiss equivalent to the regulatory initiatives of Dodd–Frank in the US and EMIR / MiFID II in the EU. Conceptually, the regulatory regime for commodity derivatives in FinMIA is largely similar to the regulatory regime for commodity derivatives in the EU. However, the practical importance of this domestic regime is currently limited. In the absence of the availability to trade on an energy commodities derivatives exchange in Switzerland, commodity firms incorporated in Switzerland will usually trade on trading venues in the EU or another third country.

### Scope of financial instruments

The definition of “derivative contract”<sup>102</sup> covers financial contracts, the price of which is derived specifically from assets (such as shares, bonds, commodities and precious metals) or reference values such as currencies, interest rates and indices. The definition expressly excludes spot transactions, derivative transactions relating to electricity and gas which are traded on an OTF and subject to additional requirements, and derivatives transactions relating, for example, to climatic variables, freight rates, or other official economic statistics that are settled in cash only in the event of a default or other termination event.<sup>103</sup>

### Position Limits

The Swiss position limits regime perfectly exemplifies the limited relevance of the regulatory regime for the domestic market. Although FinMIA<sup>104</sup> establishes a delegation of power to the Federal Council to specify position limits, the Federal Council has not yet specified any position limits. There is no domestic market in Switzerland which leaves market participants to trade commodity derivatives on EU or third country trading venues; those venues are then subject to the position limit regimes in those jurisdictions. Swiss market participants will therefore be subject to the position limits regime applicable to the trading venue.

### Hedging exemption

FinMIA contains a hedging exemption for position limits which is limited to NFCs. However, on the basis that the Federal Council has not yet specified any position limits, this exemption currently has no practical importance in the domestic market.

### Pre-trade transparency for energy derivatives

FinMIA contains a pre-trade transparency regime for ETDs. However, there is currently no exchange for commodities trading in Switzerland, thus the practical importance is limited as, to date, the rules have not been tested.

#### Lessons learned

Although the regulatory regime for commodity derivatives in Switzerland is largely similar to the EU regime, the practical importance of this domestic regulatory regime is currently limited in the absence of the ability to trade on an energy commodities derivatives exchange in Switzerland. A more robust internal market in the future may eventually be able to provide a substantive comparison between two regions using functionally comparable regulatory environments.

102 Art. 2(2) of the Financial Market Infrastructure Ordinance.

103 Art. 2(3) of the Financial Market Infrastructure Ordinance.

104 Art 118 FINMA: (1) The Federal Council may introduce limits on the size of net positions which a person may hold in commodity derivatives insofar as this is necessary for orderly pricing and settlement as well as for convergence between prices on the derivatives market and on the underlying market. In doing so, it shall take account of recognised international standards and legal developments abroad. (2) It governs the following for position limits: (a) the calculation of net positions; (b) the exemptions for positions which are held for a non-financial counterparty and which serve to reduce the risks directly associated with its business activity, liquidity management or asset management; (c) the reporting duties required for the transparency of commodity derivatives trading. (3) FINMA shall set position limits for the individual commodity derivatives.

## 4.5. Conclusion

Comparing these regimes to the EU does not necessarily involve an exact comparison because of their varying scopes. However, it is possible to do so at a relatively high level for the purposes of this report. As we might expect, the regime that is closest in scope to the EU is Switzerland, as it has been designed with that very comparison in mind. However, this might also make it the least useful jurisdiction to learn lessons from. In any event, Switzerland is not able to offer many practical insights into the application of the rules as it has not had cause to use many of them in the absence of a domestic energy derivatives market. Most organisations in Switzerland trade their commodity derivatives on exchanges in other countries and are thus bound by the regulatory regimes of those countries.

The US and Singapore provide two alternatives to the EU model of position limits. The US version is a hybrid with a handful of contracts subject to federal position limits while the rest are set by exchanges, also making the exchanges responsible for the hedging carve-out. The Singapore position limits regime goes further and assigns exchanges the authority to set all position limits but stops short of allowing exchanges to grant hedging exemptions. The US pre-trade transparency regime is closer to the EU in the sense that it has one; however, pre-arranged trading is prohibited on SEFs save for block trades which conceptually reflects the EU large in scale waiver, if not in detail. Unlike the EU, the Singapore regime does not have a pre-trade transparency regime. On the other hand, in the US, pre-arranged trading is prohibited on the main futures exchange but subject to certain conditions which, again, broadly reflect the EU's pre-trade transparency waivers.

**Figure 19: Comparison of the EU regulatory landscape with international jurisdictions**

	Position Limits	Hedging Exemption	Pre-trade transparency
EU	NCA's impose position limits on all commodity derivatives traded on trading venues and any EEOCTs in accordance with methodology set by ESMA. They apply to the net position held by any person and that is held on its behalf at an aggregate group level.	Position limits do not apply to positions in commodity derivatives held by, or on behalf of, non-financial entities and which are "objectively measurable as reducing risk directly related to the commercial activity of that non-financial entity" where that non-financial entity has applied for an exemption.	Market operators and investment firms operating trading venues must make public their bid and offer prices as well as the depth of the trading interests. An NCA can grant waivers for market operators and investment firms operating trading venues. These are available for, among others, orders that are LIS, derivatives "for which there is no liquid market" and orders for the purpose of executing exchange-for-physical and package transactions (subject to conditions).
US	Unlike in the EU, position limits are set at federal level for only a few agricultural contracts. For all other contracts the exchanges determine the limits.	Unlike in the EU, the exchanges are responsible for granting and administering hedging exemption for position limits.	The US does have a pre-trade transparency regime, but unlike the EU regime, pre-arranged trading is expressly prohibited on SEFs with an exemption for block trades (which reflects the large in scale waiver in the EU).
Singapore	Unlike the EU, position limits in relation to ETD contracts are set and administered by the exchanges using their own methodology.	The regulatory regime in Singapore does not contain a hedging exemption similar to the hedging exemption under MiFID II.	There is no statutory pre-trade transparency regime. The Singapore Exchange Futures Trading Rules provide that members of the exchange and approved traders shall not make any purchase or sale which has been pre-arranged except in limited circumstances (which reflect the EU's large in scale waiver).
Switzerland	Swiss legislation, much like the EU regime, delegates the power to set position limits to a regulatory body. However, this power has not yet been exercised.	Similar to the EU regime, the Swiss regime contains a hedging exemption for position limits. The exemption is also limited to NFCs.	As in the EU, the Swiss regime contains a pre-trade transparency regime for ETDs. However, there are currently no exchanges for commodities trading in Switzerland and therefore the rules, to date, have not been used.

While comparison of the different jurisdictions does reveal some interesting approaches and methodologies, it is difficult to draw conclusions from the experience of other jurisdictions because differences in the detail of the requirements or the commercial composition of the markets means a 'like-for-like' comparison is not possible. In addition, each approach has been adopted by each jurisdiction for a reason, even though it might not work perfectly for all participants in that market. Any attempt to apply the same regime in another jurisdiction may only serve to amplify its flaws rather than incorporate its benefits. It is useful, however, to know that there is precedent for both applying position limits to a smaller set of commodity derivatives (as acknowledged by ESMA) and/or delegating the task of determining them to the exchanges. The key lesson to be learned in relation to pre-trade transparency is the importance of permitting large in scale trading to take place outside the regulated market, even with those jurisdictions that ban pre-arranged trading with an exemption for block trades.



## 5. Key policy recommendations

## Financial services legislation that works for energy markets: Europex recommendations

The preceding sections of this report sought to present the financial services regulatory landscape, capturing European energy exchanges together with their members, participants and clients. We also attempted to describe the practical implications of regulatory change on the energy markets post-2008. Finally, we considered how the experiences of major international jurisdictions compared to the European framework and what insights we could take from them. The report considered the unique characteristics of the European energy markets, including energy exchanges specifically as well as the interplay between the energy and financial services markets. Among other issues, we also considered the broader challenges facing the European energy markets, notably their leading role in facilitating the transition towards the climate-neutral economy in line with the 2050 targets.

On the basis of this analysis, Europex has put together the following recommendations for the European Commission and European regulators on how to approach future amendments to the existing European regime. Any changes to the regime should be undertaken with an emphasis on making it more fit-for-purpose for physical energy and energy derivatives markets and their participants. Given the specific characteristics of the energy markets, the below recommendations should be understood as applicable to derivatives on power and gas only, rather than all commodity derivatives.

Europex recommendations are grouped under five high-level principles that are designed to form guidance for specific legislative, regulatory and/or policy action. This non-sequential list of high-level priorities includes – (1) Securing competitiveness of European energy markets, (2) Reflecting the special characteristics of the European energy markets, (3) Ensuring proportionality vis-à-vis physical market participants, (4) Recognising the importance of financial entities for the energy derivatives markets and (5) Simplifying and streamlining the legislative and regulatory framework. Detailed recommendations set out Europex views on the key financial services regulatory issues affecting European energy markets; these recommendations include a call to limit the scope and application of position limits for commodity derivatives as well as to adjust the calibration of the pre-trade transparency regime for energy derivatives to reflect energy market reality. This suggests that financial services regulation should properly accommodate the characteristics of various energy market participants, including financial and non-financial entities, as well as a general call for a simplified, streamlined and balanced approach to regulation.

## Principle 1: Securing competitiveness of European energy markets.

### Recommendation 1

**Ensure that the position limits regime for commodity derivative markets does not adversely affect the development of the European energy markets.**

While we believe that the position limits regime has generally functioned well for major and the most liquid benchmark energy contracts, the regime in its current form has had an unintended adverse impact for smaller, illiquid and/or new contracts. Further, this regime has unintentionally damaged the level playing field between exchanges offering liquid competing contracts with the same physical underlying. The regime for liquid contracts may contribute to pushing liquidity to the exchange with the highest open interest. As such, targeted adjustments to the regime, focused on limiting its application to the major benchmark contracts and applying the same position limits to competing contracts that are assessed as 'critical' are needed to ensure that it continues to deliver on its policy objectives. We believe that such amendments will provide additional incentives for the development of the European energy derivatives markets, including further expansion of offering Euro-denominated contracts.

### Recommendation 2

**Provide a regulatory framework that does not encourage market participants to shift their power and gas derivative business to third-country jurisdictions and/or OTC.**

Energy derivatives markets make up a large part of the global marketplace, as such their participants are often international market participants. These participants are able to transfer their trading businesses between jurisdictions with relative ease depending on which best suits their interests. We are convinced that a carefully calibrated adjustment to the regulatory framework governing European commodity derivatives markets will improve their long-term, innovation-driven development and commercial appeal to such international market participants. These adjustments should focus on, but not be limited to, the scope of the position limits regime, broader availability of the hedging exemption and calibration of the pre-trade transparency regime.

### Recommendation 3

**Provide a consistent, predictable and robust regulatory framework that fosters innovation in the energy markets.**

The European energy markets will continue to lead efforts towards the energy transition and achieving the 2050 targets of a climate-neutral economy. Energy exchanges provide solutions for the growing ranks of renewable energy producers, users and investors in renewable energy projects who seek to hedge their commercial risks stemming from such engagements. To facilitate those efforts, we believe that an appropriately calibrated regulatory regime is critical to provide a suitable environment for innovation in the energy markets to flourish and to drive positive change in other sectors. This will allow the European energy exchanges to respond to customers' demand in a manner correlated with the pace of market developments and, as such, further contribute to the coordinated cross-industry efforts towards tackling climate change.

## Principle 2: Reflecting the specific characteristics of the European energy markets.

### Recommendation 4

**Ensure that the rules governing the pre-trade transparency requirements for the energy derivatives markets are appropriately calibrated for in-scope gas and electricity products.**

Recognising the vital importance of the pre-trade transparency regime for the functioning of the European commodity derivative markets, we consider that its current calibration prevents any substantial increase in volumes traded on exchanges and cleared through CCP clearing houses, which would ensure a high level of security and transparency for energy derivatives transactions. Thus, without the necessary adjustments, the regime will not be able to provide its benefits to the energy markets. The ill-calibrated methodology for the IL and LIS threshold calculations leads to flawed results. Currently, both the LIS threshold (EUR 500,000 notional value of a trade) and liquidity thresholds (10 daily average number of trades / EUR 10,000,000 average daily notional amount) for energy derivatives are too disconnected with market reality to provide any meaningful reference. Therefore, among other issues, a change to the methodology for LIS thresholds and liquidity calculations is required for the regime to fully reflect the characteristics of the European power and gas markets.

### Recommendation 5

**Adjust the commodity derivatives position limits regime in a manner that is proportionate to the nature and risk profile of the energy markets and their participants, including by taking due consideration of the corresponding rules set out by the REMIT and MAR regimes.**

While an appropriately designed position limits regime for commodity derivatives can bring added value to the overall functioning of such markets, its overly prescriptive, rigid and expansive application has had the opposite effect. In addition to the position limits regime, market conduct in commodity derivative markets is already subject to expansive regulation, including bespoke rules for gas and electricity markets as set out by REMIT and the general anti-market abuse regime of MAR. We are therefore of the view that carefully calibrated amendments to the regime that take due account of the non-systemic nature of the risk profiles of energy derivatives market participants are necessary to reflect the characteristics of European energy markets.

### Recommendation 6

**Develop a regulatory framework that allows European energy markets to continue providing vital interplay between physical energy and energy derivatives markets.**

European energy markets provide a unique gateway for financial and physical markets to interact; for them to function in a balanced and harmonised way, the energy markets must be underpinned by an appropriately calibrated regulatory framework. Financial markets are the place where physical market participants come to hedge risks stemming from their commercial operations. For this reason, access to financial markets and the instruments they offer is vital for operational and strategic purposes of physical businesses. New global challenges, including efforts towards creating a climate-neutral European economy by 2050, create new demands for the European energy markets as they assume a key role in facilitating the energy transition for European businesses. European energy markets contribute to the energy transition by providing innovative traded energy products to facilitate the specific hedging needs of renewable energy market participants, among other services. As such, the regulatory framework needs to reflect the variety of market participants and the real-economy implications of their business activities.

### Principle 3: Ensuring proportionality vis-à-vis physical market participants

#### Recommendation 7

**Ensure that compliance with regulation does not create unnecessary barriers to entry for smaller and/or new physical market participants.**

Energy markets are characterised by diverse membership, ranging from large and sophisticated financial entities, through large physical market participants such as energy producers and professional traders, to smaller users. We note that the current efforts towards energy transition will likely result in an even more diversified trading environment – including new RES producers, storage providers, large-scale prosumers and others. To this end, we encourage the development of regulatory frameworks that carefully recognise the levels of risk represented by the in-scope persons and, in particular, the fact that small and unsophisticated physical market participants represent little, if no, systemic risk. While we support appropriately calibrated, sound and robust regulatory frameworks as they can help bring confidence to organised marketplaces, we believe that they should be designed in a way that does not create barriers to entry for such small or new participants.

#### Recommendation 8

**Maintain a simple and workable ancillary activity exemption that allows physical market participants with limited activities in financial markets to use simplified rules.**

Following on Recommendation 7, we note that the current ancillary activity exemption that allows physical market participants to continue participating in commodity derivative markets, albeit subject to conditions and ongoing monitoring, is an example of the type of balanced approach to regulation that we support. At the same time, we note the challenges posed to the functioning of the ancillary activity exemption based on quantitative and qualitative tests following the UK departure from the EU. We believe, however, that a simple and practical ancillary activity exemption should be put in place in the upcoming review of the MiFID II framework.

#### Recommendation 9

**Recognise the importance of pre-arranged transactions for energy markets, in a proportionately calibrated and harmonised pre-trade transparency regime applicable to such transactions.**

Pre-arranged transactions are a common characteristic for energy derivatives markets. They play a crucial role for commercial energy market participants by allowing them to conduct hedging activity to manage risks stemming from their day-to-day business operations. However, the current pre-trade transparency regime for commodity derivatives includes an element of uncertainty in the application of the pre-trade transparency hedging exemption to pre-arranged transactions due to the lack of clear legislative provisions. It is important, therefore, that the revised MiFIR framework provides more certainty and legal clarity on the application of the pre-trade transparency regime to pre-arranged transactions.

#### Recommendation 10

**Ensure that regulatory requirements applicable to financial entities do not result in adversely affecting their client business, including the provision of access to derivatives trading and clearing services.**

Many smaller physical market participants rely on financial entities to access commodity derivatives markets and hedge their commercial exposures. For such smaller market participants to continue actively using the benefits of energy derivatives markets, the overall requirements imposed by regulation should not create disincentives, prudential or other, for financial entities to continue accepting such small physical market participants as clients.

## Principle 4: Recognising the importance of financial entities for the energy derivative markets.

### Recommendation 11

**Introduce permission for financial entities to use the hedging exemption from the position limits regime when trading on behalf of non-financial entities and/or providing liquidity for trading venues listing energy derivatives contracts.**

Financial entities are often meaningful liquidity providers in energy derivative markets. Therefore, we believe that the legislative and regulatory framework should encourage their participation rather than dissuade them from it. Such a limited extension of the hedging exemption would help new and illiquid energy derivative contracts, which are currently often sealed in their illiquid status due to regulatory constraints, develop and further enhance the overall competitiveness of the European energy markets. It would also help support the efforts of the European energy markets in contributing to the energy transition by facilitating access to a broader set of specialised products allowing the execution of climate change-related hedging strategies.

### Recommendation 12

**Adjust the pre-trade transparency regime for commodity derivatives in a manner that allows financial entities to use the hedging exemption when trading on behalf of non-financial, physical market participants.**

We strongly support the high levels of transparency in the energy markets. However, we are of the view that in order to encourage certain liquidity providers to remain active in those markets, some regulatory incentives are required. The use of the hedging exemption from the pre-trade transparency regime by financial entities in justified cases would be such an incentive, balancing the risks that liquidity providers take on as a result of their trading activity.

### Recommendation 13

**Take due consideration of the overall impact that financial services regulation, including prudential requirements, have on European financial entities that are participants in energy markets.**

The unprecedented expansion of the post-2008 financial services regulation had a profound impact on re-shaping the modern financial markets. With the safety and stability of financial markets being of vital importance to the functioning and development of energy markets, we remain cautious that the overall regulatory burden that financial market participants are subject to does not result in those participants curtailing their activities in energy markets. This, in our view, would have highly disruptive effects, including a decrease in much valued market liquidity. It could also discourage provision of access to financial markets for smaller and less sophisticated physical market participants.

## Principle 5: Simplifying and streamlining the regulatory framework.

### Recommendation 14

#### **Limit the complexity of regulatory reporting requirements, including by identifying and eliminating overlapping data reporting fields.**

We recognise the benefits that supervisory reporting requirements, when properly calibrated, can bring for the purposes of supervision and early detection of emerging risks. We are sceptical, however, that the current levels of complexity as illustrated by the various supervisory reporting requirements applying to energy derivatives across multiple pieces of legislation, serve to achieve this objective. To this end, we encourage the European Commission and the legislators to follow up on the “Fitness Check of the EU Supervisory Reporting Requirements” with tangible proposals on how to simplify and streamline regulatory reporting requirements for market practitioners who trade in energy derivatives which fall, at the same time, within the scope of REMIT and the broader scope of financial legislation.

### Recommendation 15

#### **Conduct a comprehensive review of regulatory reporting requirements leading to a comprehensive approach to regulatory change.**

Following on from Recommendation 14, while recognising the shortcomings of the current regulatory reporting framework, we encourage a comprehensive approach to energy derivatives regulatory reporting change. We are of the view that piecemeal and fragmented adjustments, albeit well-intentioned, will only add to the complexity of the regime.



## Annex I: Full definition of commodity derivative under MiFID II

Under Article 4(1)(50) of Directive 2014/65 (EU) (**MiFID II**):

- 'commodity derivatives' means commodity derivatives as defined in Article 2(1)(30) of Regulation (EU) No 600/2014.

Under Article 2(1)(3) of Regulation (EU) No 600/2014 (**MiFIR**):

- 'commodity derivatives' means those financial instruments defined in point (44)(c) of Article 4(1) of Directive 2014/65/EU; which relate to a commodity or an underlying referred to in Section C(10) of Annex I to Directive 2014/65/EU; or in points (5), (6), (7) and (10) of Section C of Annex I thereto.

Under point (44)(c) of Article 4(1) of Directive 2014/65/EU (MiFID II):

- 'transferable securities' means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as: (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

Annex I points (5), (6), (7) and (10) of Section C of Directive 2014/65/EU (**MiFID II**):

- (5) Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;
- (6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are

traded on a regulated market, an MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled;

- (7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 of this Section and not being for commercial purposes, which have the characteristics of other derivative financial instruments;
- (10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, an OTF, or an MTF.

## Glossary

<b>ACER</b>	Agency for the Cooperation of Energy Regulators
<b>BA</b>	Benchmark Administrator
<b>BMF</b>	German Federal Ministry of Finance (Bundesministerium der Finanzen)
<b>CCPs</b>	Central Counterparties
<b>CDS</b>	Credit Default Swap
<b>CFTC</b>	US Commodity Futures Trading Commission
<b>COFIA</b>	Class of Financial Instrument Approach
<b>DCM</b>	Designated Contract Market
<b>EBA</b>	European Banking Authority
<b>ECON</b>	European Parliament Committee on Economic and Monetary Affairs
<b>EEOTC</b>	Economically Equivalent OTC contract
<b>EEX</b>	European Energy Exchange AG
<b>EFET</b>	European Federation of Energy Traders
<b>ESMA</b>	European Securities and Markets Authority
<b>ETD</b>	Exchange-Traded Derivative
<b>EU</b>	European Union
<b>Europex</b>	Association of European Energy Exchanges
<b>FCs</b>	Financial Counterparties
<b>FCA</b>	UK Financial Conduct Authority
<b>FINMA</b>	The Swiss Financial Market Supervisory Authority
<b>FinMIA</b>	Swiss Financial Market Infrastructure Act
<b>GTMA</b>	Grid Trade Master Agreement
<b>IBIA</b>	Instrument By Instrument Approach
<b>ICE</b>	Intercontinental Exchange
<b>IOSCO</b>	International Organisation of Securities Commissions

<b>IOSCO Principles</b>	Principles for the Regulation and Supervision of Commodity Derivatives Markets
<b>LIS</b>	Large In Scale
<b>LIBOR</b>	London Inter-Bank Offered Rate
<b>LNG</b>	Liquefied Natural Gas
<b>MAS</b>	Monetary Authority of Singapore
<b>MTF</b>	Multilateral Trading Facility
<b>NCA</b>	National Competent Authority
<b>NFC</b>	Non-Financial Counter-party
<b>NFE</b>	Non-Financial Entity
<b>NFC+</b>	A Non-Financial Counterparty whose positions in non-hedging OTC derivatives exceed certain thresholds defined by ESMA and that therefore is subject to the clearing obligation and risk mitigation techniques requirements provided for in EMIR
<b>NFC-</b>	A Non-Financial Counterparty whose positions in non-hedging OTC derivatives do not exceed certain thresholds defined by ESMA and therefore is not subject to the clearing obligation and risk mitigation requirements provided for in EMIR
<b>NRA</b>	National Regulatory Authority
<b>OMP</b>	Organised Market Place
<b>OTC</b>	Over-the-counter
<b>OTF</b>	Organised Trading Facility
<b>PPA</b>	Power Purchase Agreement
<b>SEC</b>	US Securities and Exchange Commission
<b>SEF</b>	Swap Execution Facility
<b>TSO</b>	Transmission System Operator
<b>Withdrawal Agreement</b>	Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community

# Legal References

## Financial Legislation

<b>BMR</b>	Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds
<b>CDR 149/2013</b>	Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP
<b>CDR 153/2013</b>	Commission Delegated Regulation (EU) No 153/2013 of December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties
<b>CDR 2017/565</b>	Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive
<b>CDR 2017/583</b>	Commission Delegated Regulation (EU) 2017/583 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives
<b>CDR 2017/591</b>	Commission Delegated Regulation (EU) 2017/591 of 1 December 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits to commodity derivatives
<b>CRR</b>	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012
<b>CSMAD</b>	Directive 2014/57 (EU) of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive)
<b>Dodd-Frank Act</b>	US Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
<b>EMIR</b>	Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
<b>EMIR Refit</b>	Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories

<b>FinMIA</b>	Swiss Financial Market Infrastructure Act 2015
<b>IFR</b>	Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014
<b>MAR</b>	Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation)
<b>MiFID</b>	Directive 2004/39 (EC) of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments
<b>MiFID II</b>	Directive 2014/65 (EU) of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments
<b>MiFIR</b>	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments
<b>SFA</b>	Singapore Securities and Futures (Amendment) Act 2001

## Energy Legislation

<b>First Energy Package</b>	<p>Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity</p> <p>Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 concerning common rules for the internal market in natural gas</p>
<b>Second Energy Package</b>	<p>Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC and Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC</p>
<b>Third Energy Package</b>	<p>Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC</p> <p>Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC</p> <p>Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators</p> <p>Regulation (EC) No 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003</p> <p>Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005</p>
<b>REMIT</b>	<p>Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency</p>
<b>Clean Energy Package</b>	<p>Directive (EU) 2019/944 of the European Parliament and of the Council of 5 June 2019 on common rules for the internal market for electricity and amending Directive 2012/27/EU</p> <p>Regulation (EU) 2019/943 of the European Parliament and of the Council of 5 June 2019 on the internal market for electricity</p> <p>Regulation (EU) 2019/942 of the European Parliament and of the Council of 5 June 2019 establishing a European Union Agency for the Cooperation of Energy Regulators</p> <p>Regulation (EU) 2019/941 of the European Parliament and of the Council of 5 June 2019 on risk-preparedness in the electricity sector and repealing Directive 2005/89/EC</p>

Regulation (EU) 2018/1999 of the European Parliament and of the Council of 11 December 2018 on the Governance of the Energy Union and Climate Action, amending Regulations (EC) No 663/2009 and (EC) No 715/2009 of the European Parliament and of the Council, Directives 94/22/EC, 98/70/EC, 2009/31/EC, 2009/73/EC, 2010/31/EU, 2012/27/EU and 2013/30/EU of the European Parliament and of the Council, Council Directives 2009/119/EC and (EU) 2015/652 and repealing Regulation (EU) No 525/2013 of the European Parliament and of the Council

Directive (EU) 2018/2002 of the European Parliament and of the Council of 11 December 2018 amending Directive 2012/27/EU on energy efficiency

Directive (EU) 2018/2001 of the European Parliament and of the Council of 11 December 2018 on the promotion of the use of energy from renewable sources

Directive (EU) 2018/844 of the European Parliament and of the Council of 30 May 2018 amending Directive 2010/31/EU on the energy performance of buildings and Directive 2012/27/EU on energy efficiency



