Public Consultation on CESR's/CEBS's technical advice to the European Commission on the review of *commodities business*

– Response of the ECT-Group –

I. Introduction

We are representing the Energy Commodity Traders Group ("ECT-Group"), a group of German energy trading firms which established a joint working and discussion group for the exchange of experiences in financial and physical energy trading and for the co-ordination of the communication with German and European authorities. We would like to respond to CESR's and CEBS's public consultation on the review of commodities business.

The ECT-Group consists of entities active in the energy trading sector; several of them pursue also banking activities or render financial services related to energy derivative products. Entities which pursue banking activities or render financial services related to commodity derivatives are according to the German Banking Act[1] investment firms which have to apply for a license in order to carry out the banking activities or financial services related to commodity derivatives and which are supervised by the German Financial Supervisory Authority Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). The ECT-Group serves as a platform for such firms in order to develop common positions with respect to the financial supervision and to communicate them to BaFin and other legislative and administrative bodies. There has been a steady and successful cooperation between BaFin and the ECT-Group in order to develop an adequate supervisory regime for investment firms rendering financial services related to energy derivative products.

II. Statement

1)	In practice, what proportion and/or amount of *OTC commodity derivative* transactions are financial instruments falling within the *MiFID* and what proportion are spot? (a breakdown in terms of the underlying would be helpful)

Without being able to give exact figures, we would like to point out once again that especially in the areas of electricity and gas contracts the absolute majority of transactions presently do not fall within the MiFID. Most of the actors in the energy supply sector stick to the use of OTC transactions, which may be fulfilled only physically. As a result they do not constitute *commodity derivatives* in terms of MiFID and are consequently no financial instruments.

2)	Do you agree that the level of direct participation by unsophisticated investors is mainly limited to corporate clients such as producers or wholesale distributors (with a lack of

[1] Gesetz über das Kreditwesen (Kreditwesengesetz – KWG) in der Fassung und Bekanntmachung vom 9. September 1998 (BGBl. I S. 2776), zuletzt geändert durch Art. 2 des Gesetzes vom 21. Dezember 2007 (BGBl. I S. 3089).

experience and knowledge in derivatives markets but not in trading in physical *commodity markets*), that participation by private clients is very low, and that most other participants in *commodity derivatives markets* are sophisticated firms?

According to the experience and observations of the ECT-Group there are no private investors in the area of energy derivatives trading. Depending on the nature of this matter, producers and distributors as well as wholesale distributors of energy operate in the market. All these companies have partially decades of experience with the purchase and sale of energy. In addition to some banks, there are some specialized energy traders that act like intermediaries or wholesalers in the market, who practically all have a corporate relation to an energy generation or supply company.

3) What informational advantages persist in *commodity derivatives markets,* and in particular to what extent do those also active in the underlying physical market have informational advantages?

4) Do information asymmetries in *commodity derivatives markets* lead to mis-selling concerns, or to other concerns about potential client detriment?

The members of the ECT Group, who according to the vocabulary used in the consultation consist of both, “sophisticated investors” and “corporate clients”, could not notice any worth-mentioning informational advantages at the individual market participants, nor did they suspect any problems here.

5) Do you have any transparency–related concerns relating to the trading of non-electricity and gas *derivatives*? If so, in which markets and why?

As a group of energy traders the ECT Group will participate in the relevant studies of CESR and ERGEG. There are no other problems known for other markets that affect the Group, like coal, oil, emission certificates or cargo rates.

6) Do you have evidence of informational asymmetries in *commodity derivatives markets* in relation to market abuse?

The ECT Group has no evidence of market abuse due to informational asymmetries. This does not mean that it would be impossible to manipulate the markets, especially as long as only few players are active in a market that is not particularly liquid (conf. the given example of cornering). Therefore, the more important is it for us to remove market access barriers in order to make the markets attractive and liquid for many trade participants.

7) Please provide any information you have on the levels of lending and trading exposures between *specialist commodity derivative firms* and *institutions.*

According to the experience of the ECT-Group the interconnection level between specialized commodity derivative traders and classic institutions is rather low.

If institutions grant a loan or have a security function for a specialized commodity derivative firm, this happens only on the basis of an exact rating/scoring of the trading firm and on an appropriate coverage of the institution. In this context, it is also of importance that the typical participant in the commodity derivative market either is asset-based or belongs to an asset-based group (like an energy supply company). Besides, the backup of trading transactions e.g. by bank guarantee is only one of many options. Corporate guarantees, parent company guarantees, letters of awareness or even the exchange of cash securities are also as frequent as or even more frequent than this option.

Furthermore, according to the observations of the ECT-Group members, classic institutions do not have an especially high exposure compared with the commodity derivative firms. The share of the institutions is low compared to the total volume of the energy trade and of the energy derivative trade the share of the institutions.

8) What level of risk do *specialist commodity derivative firms* pose to the financial system?

9) To what extent does the level of systemic financial risk posed by *specialist commodity derivative firms* differ from that generated by banks and *ISD* investment firms?

The ECT-Group joins the result of CESR and CEBS that also in their opinion the level of systemic risks posed by specialist commodity derivative firms is very low.

This is firstly related to the role that specialized commodity derivative traders and commodity traders who, if necessary, also trade with derivatives have in the whole system. For their function originates from the demands made by the market participants. They, above all, look for the hedging of their prices, be it for the sale or purchase of commodity. This means that the tendency to open positions is rather small. The specialist commodity trading firms operate in this environment and for the benefit of the rest of the market participants; i.e. they offer brokerage, consultation and portfolio management of physical contracts. Contracts to be fulfilled financially serve almost exclusively for hedging purposes.

As already addressed above (to question 2) the commodity derivative markets only consist of professional or corporate clients and not of small investors in need of protection. With their

protection systems the professional and corporate clients are notably better at controlling market risks.

At last, it should also be taken into consideration that most market participants (as well as most specialist commodity derivative firms) either are an asset-based business or belong to an asset-based group. In the energy trade these assets consists mainly of power plants or distribution systems. Irrespective of some classic institutions this means that practically all market participants have excellent ratings alone on the basis of their assets and offer the expected security. As long as these are hived off trading or supply companies they are regularly linked with the part of the group holding the assets by means of corporate guarantees, parent company guarantees or profit and loss transfer agreements.

This is also a reason why the level of systemic risk for specialized commodity derivative firms differs from the one of the classic institutions. These serve the support of small clients, they generally have no asset-based background and neither are the products they trade with physically highlighted.

10) Do the risks generated by energy-only investment firms differ materially from those posed by investment firms engaging in other commodity derivative activities/services? If so, how do they differ?

As regards the systemic risks between energy and other commodities no difference can be distinguished. Thus the basic equal treatment of all types of commodities is justified. However, it should be taken into consideration that for economic reasons it is of benefit if in particular the energy markets are used by many (also small) players so that they gain high liquidity. Especially due to the peculiarity also addressed to in the consultation that electricity is not storable and gas is only storable to a limited extent, forwards and futures contracts must be widespread. If one wishes to establish liquid market places like the energy exchange on the one hand, but declares all futures contracts which run over an exchange market or MTF to be financial instruments on the other, might end up keeping many businesses from a possible commitment. This would be an undesired political development Europe-wide. (cf. the 3rd Energy Package of the European Commission).

11) Do you have any transparency-related concerns relating to the trading of non-energy *commodity derivatives,* and, if so, in which markets, what are the concerns, and what solutions could be applied?

See above the answer to question 5.

12) Do you believe that for non-electricity and gas *derivatives* contracts, the transaction reporting requirements in the *MiFID* support market regulation? If so, can you explain why you think they do?

Irrespective of the further work by CESR-ERGEG's working group, the ECT-Group does not believe that a transaction reporting might lead to a considerable increase of transparency. Instead, the costs incurred for the companies would far exceed the only limited transparency improvement. The Group joins therefore, the preliminary view of CESR and CEBS.

Additionally, the Group supports the analysis carried out by the UK Financial Services Authority (FSA) relating to position reporting like it is carried out in the USA by CFTC. According to the assessments and experiences of the ECT-Group members the pressure on the companies due to the obligations to report would also outweigh the gained information. Should it happen that a position reporting will be installed nonetheless, a European level playing field has to be created, i.e. there can't be different national rules.

13) Do you have any evidence on potential problems, and if so, on the scale of these problems, that are posed by current client categorization rules?

Problematic for the members of the ECT-Group is the client categorization especially as regards the so-called sophisticated clients.

The current rules of the client categorization stipulate that as professional clients will come into question only certain person. However, if the criteria of balance sheet total, sales revenues and equity capital are considered, many potential clients in the energy derivatives market might not be classified as professional clients. These are businesses not subject to financial supervision, which are not governments or companies that have the aforementioned size. In the energy derivatives sector small distributors, municipal procurement companies or small producers should be taken into consideration.

These are, however, businesses that have partially years or decades of experience with energy trading. Nevertheless, they would still not be able to be classified as professional clients since they do not have regular experiences at a classic capital market and they have not traded enough financial instruments yet.

In our opinion the term „professional" should thus be broadened in such a way that the "sophisticated clients" too fall into this category. According to our experiences (some of the ECT-Group members are "sophisticated" but "non-professional clients") there are no risks to be distinguished in this regard. Even so, the businesses know what they do.

In any case, it should be rendered possible that such businesses may be classified as „professional clients" without having to face major difficulties. A possibility could be to provide that sophisticated clients are able to declare themselves as „professional" if they limit their activities to the field of their sophistication (which in the normal case would be commodity derivatives trade). This would ensure that no small investors are affected and therefore, the „protection from oneself" in the so far specified way is not necessary.

14) Do you have any evidence that regulation according to the main business of the group may cause competitive distortions?

The ECT-Group agrees on the fact that even with the current differentiation according to the main business there is no evidence for to the detriment of banks. Furthermore, there are reasons in favor of the current differentiation that are consistent with both CRD and MiFID:

As regards a CRD argumentation we join the comments made in the consultation. In our judgment the risk of purely commodity derivatives firms is not only in general lower but it is also absorbed by the main business which in the normal case is asset-based. As regards the MiFID we would like to once again refer to the market-promoting effect of the additional business exception.

With the additional business exception, the energy trader, who supplies his customers above all with physical products (thus does not trade with financial instruments), can also offer and intermediate a swap or give advice in this regard. This is the only way for the procurement by means of trading agreements to gain the necessary appeal in the energy sector; since every time a distributor purchases energy as a wholesale product he is exposed to further risks which he possibly cannot influence. If this kind of customer is not offered hedging products in an uncomplicated way or if necessary advice concerning this matter, the market will not be liberalized in the desired form. Instead, the old forms of full supply with gas and electricity by a presupplier would continue to be regarded as the optimal model, which would take players and liquidity from the market.

15) Do you agree that full application of *CRD* capital requirements to *specialist commodity derivative firms* is likely to impose a regulatory burden that is misaligned with their systemic impact?

16) Do you believe that full application of *CRD* large exposure requirements to *specialist commodity derivative firms* is likely to impose a regulatory burden that is misaligned with their business and their potential systemic impact?

The ECT-Group basically agrees with the results of the consultation paper both regarding CRD capital requirements as well as the CRD large exposure requirements. The members'

experiences show that any tightening of the supervision regime at this point would increase the market access barriers. The interest in a liquid energy trade market is to be estimated as higher than the low systemic risk reduction that would lead to a retraction or limitation of the current exceptions.

17) Do you believe there is a potential for regulatory arbitrage? If so, can you provide evidence?

Every time a European directive is not uniformly implemented in the Member States there is a potential for regulatory arbitrage. The ECT-Group members stand for a level playing field in Europe and a uniform implementation of MiFID and CRD. This comprises both sub-equivalent and super-equivalent implementations of the directives.

18) Do you believe that the application of the *MiFID* organizational requirements support the intended aims of market regulation when applied to *specialist commodity derivative firms,* or *commodity derivatives* business? If not, what aspects of the organizational requirements do you believe do not support the aims of market regulation when applied to such firms and why?

The ECT-Group basically welcomes the existence of organizational requirements as long as these are consistent with the general objectives of financial supervision and namely the investors' protection and the integrity of the financial markets. Concerning the commodity derivative firms, however, it should be taken into account that these often are very small and specialist businesses with a low staffing level. According to the experience of the ECT-Group the responsibilities arising from the organizational requirements have so far been adjusted to the volume of the individual businesses, to the company layout and the realized financial services. As long as this individualization endures, there will be no special problems. Otherwise, however, many companies would have problems carrying out the division between in a front, middle and back office in all company levels. Also very difficult to implement would be the requirements regarding the capacities of the manager position, as an appropriate candidate should have a wide experience in both, banking and energy area.

19) Do you believe that there is a case for changing the client categorization regime as it applies to *commodity derivative* business? If so, do you have any evidence on the scale of the problem or potential problem posed by the existing rules?

See above question no. 13.

20) Do you believe that the conduct of business rules in the *MiFID* effectively support the aims of regulation with respect of *commodity derivative* business? If not, can you

explain why and in what respects, and whether your response is contingent upon the client categorization definitions applied to *commodity derivative* business?

In consideration of the response to question no. 13 the ECT-Group does not see any further need for change.

21) Do each of the following elements of the criteria for determining which commodity derivatives contracts or financial instruments offer sufficient clarity to market participants to understand where the boundaries of the *MiFID* lie?

a) the phrase "…that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event)";
b) the phrase "traded on a regulated market and / or MTF"
c) the definition of a spot contract in Article 38(2) of the *MiFID* implementing regulation:
d) the criteria in articles 38(1)(a), (b), and (c);
e) the definition of a commodity in Article 2 of the *MiFID* implementing regulation; and
f) the list of underlying of exotic derivatives mentioned in Section c(10) of Annex I to the *MiFID* and Article 39 of the *MiFID* implementing regulation.

The definition of commodity derivative as financial instrument is basically sufficiently determined and applicable in practice. The ECT-Group too, sees the problem with the definition regarding the trade on MTF. What is not quite clear to the members is, however, when in terms of Article 38 Para. 1 a) iii) a contract is deemed to be equal to a future. This leads to specific questions that are posed e.g. if an energy supply company wishes to sell energy to the customer from its own portfolio on the basis of a portfolio management agreement. The use of the market price as price indicator would be appropriate here. It is, however, questionable to what extent the energy supply company may simulate other effects that arise from a direct purchase from the exchange market (like e.g. margin and clearing costs). A clarification in this respect would be appreciated.

22) Do you have any evidence of physically-settled commodity OTC contracts being written in a way that removes them from the definition of financial instruments?

There is no evidence or proof available to the members of the ECT-Group that OTC agreements have been written in a specific way as to avoid their corresponding financial instrument feature. It is, however, known that many companies that wish to ensure freedom from supervision irrespective of the further existence of the additional business exemption (Article 2 Para 1 i) would quit using the stock exchange such as EEX although they would just purchase physically delivered products.

23) Do you believe there are sufficient similarities between different *commodity derivatives market* to make it inappropriate to differentiate the regulatory regime on the basis of the underlying being traded?

The ECT-Group does not see need for changes.

24) If the capital treatment of *specialist commodity derivatives firms* is resolved, do you think there is still a case for retaining both of the exemptions in Articles 2(1)(i) and (k)? If not, how do you think the exemptions should be modified or eliminated? If the exemptions in Articles 2(1)(i) and (k) were eliminated, what effect do you think this would have on *commodity derivatives market*?

The ECT Group covers – except for banks – the full range of energy trading companies. The question of MiFID exemptions is especially relevant for such companies which either because of their size or their connection to energy supply cannot, do not wish or are not allowed to become a financial service company. This for instance applies to bigger municipal utilities or procurement companies which combine the supply of electricity or gas for their shareholders.

For these companies it is absolutely necessary to keep the exemptions in Articles 2(1)(i) and (k). They would not benefit from the easement of the obligation to deposit equity capital for specialist commodity derivative firms since they would not become such firms.

A group of small energy supply companies (municipal utilities) shall serve as example: When they merge they bundle a demand for which it is economically interesting not to be supplied with energy by means of full supply but by means of portfolio management. For this purpose the total demand on energy will be split up in elements some of which can be obtained as standard products at the wholesale. These standard products will be obtained by one company for the others or by the jointly founded procurement company. This can be done by means of intermediaries or proprietary trading.

Without the additional business exemption physically delivered forwards on the OTC market can be procured but not physically delivered futures from an energy exchange. Price hedging would not be possible and no advice should be given in this regard. Neither the exemption for trading on own account nor the trust privilege could help the companies.

None of the small companies would take it on to apply for a MiFID permission and to bear the consequence connected herewith. Nevertheless, according to the experiences of the ECT-Group there is ample consent (among the regulators too) that these companies do not have to be supervised.

In case the exemptions would be eliminated this would mean a clear loss of liquidity and diversification for the energy derivatives markets. This would mean a step backwards to the old full supply agreements from the time before the liberalisation of the energy markets.

Every modification of the exemption has to be closely examined as regards its impact: Presently the exemption refers solely to the kind of activity but not to factors such as business intensity or type of business of the actor (Exception: The group may not have banking or securities transactions as main business.).

The proposed changes (as well as the connection to the deposit equity capital) base on the assumption that the other exemptions will not be needed in practice for the commodity derivatives firms, since these are so large and professional that they can easily bear the burden of the MiFID permission. In return these companies benefit from the European passport. On the opposite side of the supervision scale are the companies whose derivatives trade activities do not exceed the material limit, and therefore cannot be called an “activitiy as a regular occupation”. Between these two there is – at least in the energy sector – a large group of companies with derivatives trading activities that would do it as a regular occupation but not to the extent which would justify the full organisation of a financial service company.

A classification according to criteria such as size, trading activity would be the only correct way: Companies with activities below such a threshold could claim the exemption, whereas those whose activities exceed the threshold could not. But this kind of classification is not included in the MiFID system. Every classification of this kind would in turn cause difficulties for the definition, the criteria might become old due to the development of the market or they would have to be updated regularly by means of the Lamfalussy procedure.

Thus in the interest of the market the exemptions should not be eliminated or limited: The adequate solution is to keep the exemptions and to supervise the large companies which so far have seen the equity capital rules as the biggest obstacle for themselves by an opt-in system.

25)	Do you believe based on the above analysis that the application of the CRD large exposures regime to specialist *commodity derivatives* firms is disproportionate?

The ECT Group agrees with the results of the consultation that an application of the large exposures regime to specialist *commodity derivatives* firms is disproportionate.

26)	Do you agree that the maturity ladder approach is unsuitable for calculating capital requirements for non-storable commodities? If yes, are the proposed alternatives better suited to that task?

Members of the ECT-Group share the opinion that the maturity ladder approach is unsuitable. Especially in the energy market the spot prices are often higher than the future prices because of energy's unstoreableness.

29) Do you agree with the conclusion above?

See above question 10.

30) Which of the options presented above do you consider appropriate for the application to *specialist commodity derivatives firms*?

The members of the ECT-Group approve of the use of the Alternative Approach which was suggested as option 1. We agree with the reasons of the originator of the Alternative Approach for this kind of supervision regime.

31) Do you think a complementary opt-in or opt-out regime could be helpful?

The ECT-Group is presently not able to give a concluding statement to the idea of an opt-in or opt-out regime and the effect of losing the exposure class "institution" yet. The sense of this addition very much depends on the form of options 1 – 3.

At first glance some members consider this idea quite interesting. A final valuation can only be given after it becomes clear which charges would be replaced and which consequences the other market participants would suffer from this.

On the other hand other members see the danger of ousting for companies that chose an opt-out. In case the market develops in such a way that business activities with companies within the CRD regime become more attractive, it might happen that companies not being able to afford the equity capital deposit will be ousted from the market. At the same time this could mean that the opt-in model will develop a pull effect, rendering useless all advantages regarding flexibility, which such an option model should offer.

In the view of the ETC-Group, the best solution would be to keep the present exemptions or if necessary the implementation of the so called Alternative Approach without additional option model. In any case the unmodified application of the complete CRD regime to the specialist derivative traders has to be avoided since this would eliminate a multitude of companies from the market and would create extremely high barriers to market access.

We would be very pleased to obtain the opportunity to discuss this topic further with representatives of the Commission may it be in person, per mail or telephone. If you have questions or comments, please, feel free to contact the representatives of the ECT-Group

whose contact details are given below. For further information about the ECT-Group and its activities you may also refer to its website under www.ect-g.de.

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