

27/07/2004

**IMPLEMENTING MEASURES FOR THE DIRECTIVE ON FINANCIAL
INSTRUMENTS MARKETS**

CESR's second mandate - Call for evidence

RESPONSE OF FRENCH BANKING FEDERATION

The Fédération Bancaire Française (French Banking Federation, FBF), the professional body representing over 500 commercial, cooperative and mutual banks operating in France.

As an active participant in the legislative process that led to the adoption of the Financial Instruments Markets Directive (MiFID) as well as in CESR consultations related to previous directives, the FBF fully supports CESR's practice of issuing a call for evidence before starting its preparation of technical advice, and is grateful for the opportunity to provide comments at this early stage.

For this reason, following CESR's call for evidence on 29 June, FBF wishes to submit some observations.

The updated indicative timetable is welcome

FBF first wishes to thank CESR for having updated the indicative timetable for its work on the FIM directive. This initiative, which is consistent with what we have advocated in the past, gives participants a clear and precise view of the different phases of the reflection process. In a context where everyone is trying to allocate the available resources as best they can, this timetable enables interested parties to organise themselves in order to contribute as constructively as possible to CESR's reflection.

Find the right balance between the need to regulate and the desire for the greatest possible harmonisation, on the one hand, and the danger of introducing inappropriate over-regulation on the other

Much of the debate about the Lamfalussy process hinges on differentiating between measures that ought to belong to level 2 and those that should belong to level 3. That issue is all the more critical in the present case. A lot of criticisms has been expressed during the last *Open Hearing* on the "too detailed" approach of CESR in its consultative paper.

Taking that into consideration, FBF believes it useful to confirm its position in this matter. Naturally, we are not in favour of over-regulation, which would hinder the development of investment service providers and make it harder for them to bring out new services or products in response to demand from issuers and investors. We nevertheless observe that an inadequately defined level 2 may prompt a national regulator to introduce particular provisions into its own legal framework in order to fill the identified gaps.

This situation would tend to preserve the fragmentation that stands in the way of achieving a true single market. To head off such a situation, FBF considers it necessary that level 2 should have real content which, without leading to harmful over-regulation, sets precise limits on the ability of national regulators to add additional requirements at the domestic level. From that point of view, FBF does not criticize the “too detailed” approach of CESR on best execution, execution only and pre trade transparency for example which, in most cases, should enhance harmonisation at European level.

List of financial instruments (article 4 – annex 1 section c)

The French Banking Federation (“FBF”) has a long history of interest in the world of commodities derivatives. It has been prominently involved in the new drafting of FIMD on the commodity derivatives definition.

In this perspective, the FBF is keen on emphasising some key elements that matter when analysing the business of commodity derivatives trading. This paper is meant to serve as a basis for discussion on CESR’s second mandate.

It strongly wishes to participate in any consultation on this subject and seizes the “Call for evidence” as an opportunity to further set out its views on the subject. FBF joins specific paper on this issue.

ANNEX I

Characterising commodity derivatives as financial instruments or commercial contracts in the European Energy markets

This paper is a reply to CESR's Call for Evidence. It sets out items needed to understand the way energy derivatives are traded on the market to highlight relevant issues for characterising financial instruments among energy derivatives. The document also ends with a proposed set of characteristics of a financial instrument as needed for level 2 of EU Directive FIMD (formerly named ISD2).

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CESR rightfully underlined in its Press release that EU financial markets in Europe encountered structural modifications since ISD1 passed in 1993. This most notably happened in Energy derivatives markets:

- Back then in 1993, energy markets were nascent but a number of exchanges or marketplaces developed throughout Europe since then :
 - ✓ for gas trading, new OTC platforms ("hubs") were set up: NBP in 1996, Zeebrugge in 1999 followed by the Dutch TTF in 2003 to mention the most active trading hubs;
 - ✓ for power trading, national OTC wholesale markets were supplemented by exchanges (UKPX, Powernext, EEX, APX...);
- Energy markets became more similar to traditional financial markets in their structure. Hence, liquidity and price transparency improved.

Most counterparties trade under master agreements and trade standard contracts. Price transparency improved through electronic trading platforms, and usual risk mitigation tools such as margin agreements became widespread.

CESR is right to point the need to adapt EU regulation in order to allow further integration of financial markets: ISD 93 did not explicitly govern forward contracts on commodities, depriving market participants of an effective EU passport.

CESR called for evidence and advice on clarifying the list of financial derivatives and the criteria to make it comprehensive with respect to certain types of Energy derivatives. **This note will focus on the main point of discussion, namely energy derivatives with physical settlement traded on OTC basis, and provides answers to:**

CESR advice should be detailed and precise in order to allow for a harmonised and uniform definition of the financial instruments that fall under the scope of the Directive. In responding to this mandate, CESR should have regard to recital (4) of the directive which indicates that the directive should apply to derivatives which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments.

DG Internal Market requests CESR to provide technical advice on possible implementing measures by 30/04/2005 on following issues:

(2) The conditions under which an option, future, swap forward rate agreement or other derivative contract related to commodities (which can be physically settled and is not otherwise covered by Section C.6) should be determined not to be for a commercial purpose.

(3) The conditions (other than cleared and settled through recognised clearing houses or subject to regular margin calls) for considering when a derivative contract of the type included in Annex I Section C 7 has the characteristics of other derivative financial instruments.;

1. THE CURRENT FORM OF ENERGY DERIVATIVES AND THE TRADING OF THEM INCREASINGLY RAISE SIMILAR ISSUES AS TRADING TRADITIONAL FINANCIAL INSTRUMENTS.

a) Wholesale Marketplaces ("Hubs") with physical delivery increasingly work so as to exempt participants from technical constraints making energy increasingly fungible

In Europe, the bulk of the volumes traded on energy derivatives are physically settled. Although these markets arose for the purposes of balancing physical supply (storage, warrants, plant...) and demand, their liquidity developed over the last 3 to 4 years when they became more similar to financial markets: legal framework based on ISDA-like master agreements, price transparency through electronic trading platforms, margin agreements, clearing...

Interestingly, wholesale markets have organised themselves so as to provide participants with standard rules for, among other things, dealing trades and processing nominations of energy quantities for delivery. These quantities are communicated to the hub operator – nominated by an adequate regulatory body – whose duty is to:

- Run the IT settlement system necessary to post quantities bought and sold and match quantities injected and withdrawn in the transmission network;
- Ensure delivery of nominal quantities to participants, thus making up for physical misbalance due to infrastructure problems;
- Billing participants whose long and short positions are not balanced (these imbalances are solved through a system similar to a "buy-in" procedure).

Obviously, this operator is acting as a **central settlement house** ensuring proper allocation of quantities in the system. To take an example, Transco (operating the NBP in the UK) could be compared with Euroclear or Cedel insofar as it settles and oversees energy settlements instead of bond or cash settlements.

This mechanism does not prevail outside the three existing organised gas hubs: NBP in the UK, Zeebrugge in Belgium and TTF in Holland. On other network connection points or infrastructures, transportation capacity is needed and bought on a bilateral basis between shippers and traders.

In other words, on Hubs, ownership of specific molecules is actually replaced by title of ownership: the commodity is **fungible**. This is a definitive criterion for characterising deals traded on these places as transactions falling inside the scope of financial instruments and thus outside common energy supply deals.

b) The conduct of business on Wholesale energy markets, supposedly those captured within the ISD scope, raise concerns identical to traditional markets

The sub-sectors of the energy industry that shall fall under the FIMD scope only comprise wholesale markets - not the retail energy business – where participants provide risk management services or trade financial instruments on their own accounts.

The most active trading entities in the marketplace are subsidiaries of utility or energy companies and tend to be integrated either in the up-stream (production) or down-stream (supply and distribution) businesses. Their typical trading offer is dedicated to their parent undertakings and varies across a range of activities encompassing centralised portfolio management, arbitrage or asset-backed trading, risk management, hedging production flows (gas fields, power plants, oil production or refinery). Their principal aims are to provide extra returns on assets through trading or hedging commercial margins, **usually through the use of trading hubs**.

All things being equal on these energy hubs that date back to less than 10 years, questions and issues became very similar to those of a financial market:

- **Market turnover:** Energy groups' trading subsidiaries – just the way trading desks in investment banks do – enter into a **high number of deals** for very large nominal quantities, using trading platforms, exchanges or OTC marketplaces to access liquidity. Financial markets in FX or interest rate derivatives act as a pooling of liquidity, gathering transactions that represent many times the underlying amount. For example **on the NBP hub, trading volume is 14 times the amount actually delivered, 5 to 10 times on the Zeebrugge hub;**
- **Price discovery:** brokers (such as GFI, Spectron, ICE,...) and specialised companies (such as Heren, Argus, Platt's) provide market participants with relevant real-time or closing price curves on each of these hubs;
- **Market efficiency** is an issue on these wholesale markets where some participants **can have a temporary market advantage** resulting from the position structurally implied by their production assets or flows. Hence, rules of good conduct and market oversight are **beneficial** to avoid price manipulation and improve their accuracy;
- **Regulation:** although hubs are officially under the jurisdiction of an energy regulator, more and more often we observe common inquiries and closer relationships with financial authorities. It is clearly the trend on the NBP where FSA and OFGEM have been building a close working relationship for two years.

c) Energy dealing outside recognised hubs clearly is different, may it be commercial purpose contracts or not, and should be kept outside the scope of the ISD

The difficulty of finding a proper dividing line comes from the fact that energy markets in Europe rely on physical delivery for the bulk of their transactions. Physical delivery proves therefore not to be a sufficient criterion to determine whether a transaction is carried out for commercial or for financial purposes. On trading hubs, energy operators tend to trade for balancing purposes (unmatched demand or supply) or to hedge price risk, but distribution to end-users or supply from fields or long term contracts is mostly carried out on grids outside

these hubs. We tried to prove above that the former hub-based trading is carried out for investment purposes, whereas the latter is conducted for other purposes.

The other end of the market, the retail energy business, is structurally out of the FIMD scope. It basically relies on bilateral supply or shipping contracts in which: 1) **transportation is necessary** since delivery is made out of hubs on specific locations (production plants...) and 2) **unwinding the contract is not a straightforward process**. This business has to do with security of supply and fair competition not with financial market efficiency.

The scope of ISD deals would therefore be expected to exclude any business such as for example:

- operations of freight or shipment of a commodity (cocoa, coal or oil) into a harbour facility (not being a place where an operator checks matching between delivery and acceptance) ;
- sale with distribution to an end-user from the hub to the delivery point, e.g : the supply of power from the grid to an industrial facility would not be considered as a financial transaction
- shipping gas from the Zeebrugge hub to another point where a shipping license or a transportation capacity is needed
- shipping of gas through the Zeepipe up until it arrives at a terminal (the selling on the NBP would materialise through a different transaction under NBP terms)

2. A SINGLE TEST FOR CLASSIFYING ENERGY TRADING

During level One discussions on the ISD, the difficult question was to pinpoint what difference there was between a “commercial” supply contract and, say, a “financial” forward contract with physical delivery.

We feel the important differentiating point is actually **the way the instrument is traded and valued** rather than its settlement or delivery. Since the Directive encompassed OTC derivatives as well as instruments traded on exchanges or electronic platforms, the test should focus on the conduct of operations and their structure (market structure, legal framework,...) and what characteristics make a commodity derivative trade **more likely** to be regarded as an investment service or not.

Indeed, it is possible to **pinpoint some characteristics that only belong to a derivative contract** and contrast this with a commercial contract.

Derivatives instruments (key characteristics)

Instrument	<ul style="list-style-type: none"> Linked to an underlying instrument or index Provide with leverage Marked to market on current price curves High turnover when trading (easy to unwind)
Underlying	<ul style="list-style-type: none"> Standardised definition Publicly available prices or index
Settlement	<ul style="list-style-type: none"> Notional settlement based on generic fungible underlying Cash settlement or physical delivery (exchange for physical) Settlement realised or supervised by a dedicated entity linked to the market
Legal	<ul style="list-style-type: none"> Common (oral or written) framework for transactions Confirmation for each trade Master agreements
Market	<ul style="list-style-type: none"> Exchange Electronic broker OTC market places (direct or mediated)

It is important to note that energy derivatives are at an early stage of development, and may therefore be expected to evolve substantially. Our attempts to capture financial instruments should take this factor into account.

a) A derivative transaction is to be regarded as financial when traded on hubs

We propose to add to level One elements, such as margin calls and clearing, a set of inter-related criteria that should be used to qualify a transaction as financial. Some are deducted from the specifics of trading on mature European OTC markets.

Eventually, this set of criteria should be regarded as a **set of non-exhaustive guidelines**¹. The fact that an instrument does not comply with any of the guidelines should not prevent that instrument from being considered as a financial instrument if it has the characteristics of other derivative financial instruments.

Proposed guidelines:

Physically-settled deals are deemed financial when they

- 1) *are cleared and settled through recognised clearing houses or subject to regular margin calls*
- 2) **OR** *exhibit a high similarity with financial practices, i.e. are:*
 - *Governed by industry-wide standard master agreements issued by professional associations*²
 - **AND** *traded on marketplaces [such as, for example, those listed in exhibit 1 for*

¹ As pointed out by CESR.

² How often such a criterion is updated is clearly a point for further discussion.

energy] where

- a) The volumes traded, number of active counterparties and price publicity arranged by third parties make it a liquid market as commonly recognised,*
- b) The physical delivery or transfer of title is co-ordinated by an appropriately³ authorised operator matching delivery and acceptance of energy and guaranteeing system security,*
- c) No transportation capacity is needed.*

b) A single test should be enough

Once a transaction passes the “financial” test, it is unnecessary to check the commercial criteria. Clearly, one test is enough and in this industry it is clearly more important to have a definition of what physically settled products are supposed to be financial.

c) Criteria shall adapt to future changes in market practices

The proposed test encompasses all structured and liquid notional hubs on gas and power. It should be kept in mind that other hubs would emerge in the near future that should be caught within the scope of financial regulation⁴.

3. EXPECTED BENEFITS OF OUR PROPOSED SET OF CRITERIA

Given the fact that this definition is in line with the real conduct of business on energy trading, it will create a level-playing field among markets, be they exchanges or OTC marketplaces. Their regulatory regimes will be similar on products which provide counterparties with identical risk profiles albeit with different settlement modes. It is clearly to the benefit of all participants that look-alike products be regulated the same way (e.g.: futures on an exchange and a forward contract bearing the same risk profile). Also, such a regulation is naturally bound to improve oversight on OTC markets with expertise put in common (following the example of FSA and OFGEM in the UK). Market participants will be able to benefit from a full EU passport all over the spectrum of derivatives, whether they trade them on own account or as a investment service to customers.

4. REFERENCES

- [1] – EU MIFI Directive – 30th April 2004 > [JOUE Directive MIFI 30 APR 04 eng.pdf](#)
- [2] – CESR – Final Mandate – 25th June 2004 > [final-mandate-isd_en.pdf](#)
- [2] – CESR – Call for Evidence > [CESRcallevidence.pdf](#)

³ Who is qualified to authorise local operators (e.g.: government, law, industry bodies...) and how often such a criterion is updated is clearly a point for further clarification.

⁴ Around hubs are frequently “grey points” which could develop and standardise so as to be similar to hubs in the near future. New hubs are also bound to emerge very soon, such as the PSV hub in Italy.

EXHIBIT 1: EXAMPLES OF MARKETPLACES FOR ENERGY

Gas (as at end of July 2004)

- 1) NBP (UK)
- 2) Zeebrugge Hub (Belgium)
- 3) TTF (Holland)
- 4) PSV (Italy)

Power (as at end of July 2004):

- 1) UK Power grid
- 2) French Power grid
- 3) German Power grid
- 4) Belgium
- 5) Holland