



International Petroleum Exchange

21 January 2005

Mr. Fabrice Demarigny
Secretary General
Committee of European Securities Regulators
11-13 avenue de Friedland
75008 Paris
FRANCE

Dear Mr. Demarigny

Response to CESR's Consultation Paper on Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments: Second Set of Mandates

About the International Petroleum Exchange of London Limited

The International Petroleum Exchange of London Limited ('IPE' or 'Exchange') is Europe's leading energy futures and options exchange. It was established in 1980 and provides highly regulated open outcry and electronic marketplaces where industry participants can manage their price risk exposure in the physical energy market. The Exchange offers six main energy contracts - namely Brent Crude futures and options, Gas Oil futures and options, Natural Gas futures, UK Power futures – and aims to launch European emissions allowance derivative contracts shortly. The IPE became a wholly-owned subsidiary of IntercontinentalExchange Inc. ('ICE Inc.') on 10 August 2001.

The IPE has 140 Members based mainly in the UK, continental Europe and the United States, which range from global investment banks and energy trading companies to proprietary floor traders and daily volumes represent a notional value of over €5 billion. Our main contract, Brent Crude futures, is used in the complex for determining the price of two-thirds of the world's crude oil. The IPE is regulated in the UK by the Financial Services Authority ('FSA') as a recognised investment exchange ('RIE') under the Financial Services and Markets Act 2000 and the Exchange also has secured regulatory permissions to place its electronic trading screens across the European Union, in the USA and South-east Asia.

General comments

The IPE has been actively involved in the on-going debate around the scope and content of the Directive on Markets in Financial Instruments ('MiFID' or 'Directive') and welcomes the opportunity to respond to CESR's Consultation Paper. Given the nature of the IPE's business we

would, in this instance, limit our comments to the discussion of the List of Financial Instruments for Article 4, as set out in Annex I Section C of the Directive.

Please also note that:

- (i) On 29 July 2004, the IPE submitted a detailed response to CESR's Call for Evidence on the Second Mandate which can be found at:
http://www.theipe.com/regulation/policy_docs.asp

It is worth noting at this stage that CESR has taken on board many of the comments made therein and also by other industry participants and therefore, subject to the comments set out below, the IPE welcomes the general tenor of CESR's draft advice.

- (ii) the IPE is a Member of the Futures and Options Association ('FOA') and has been involved in the drafting of the joint response prepared by, *inter alia*, the International Swaps and Derivatives Association and the FOA, and we would also align ourselves to the views expressed therein.

In preparing its advice to the Commission, we would urge CESR to be particularly mindful of the following principles:

1) Need for CESR's advice to be consistent with the Commission's stated intention in expanding the scope of the Directive to include commodity derivatives

In extending the scope of the MiFID to commodity derivatives business, the Commission made a number of statements in relation to the nature of commodity derivatives which should be caught within the scope of the Directive. These were that the definition:

- limits its reach to instruments which are constituted and traded in such a way as to give rise to regulatory issues comparable to traditional financial instruments;
- includes certain futures contracts traded on regulated markets or multilateral trading facility ('MTF') which are physically settled, where those contracts possess the "characteristics of financial instruments";
- includes other contracts for differences such as swaps which are settled only in cash and where the amounts to be settled are calculated by reference to values of a full range of underlying prices, rates, indices and other measures; and
- does not include physically-settled spot or forward exchange or commodities.

In order to ensure legal and regulatory certainty, it is imperative that CESR's draft Level 2 advice does not go beyond and is guided by the Commission's stated intention.

2) CESR's advice should, where possible, prevent scope for super-equivalence.

One of the current difficulties with operating in the field of commodity derivatives on a pan-European basis is that each regulatory authority across Europe takes a different approach to the regulation of such products. Among the Commission's original intentions in expanding the scope of the MiFID to include commodity derivatives was to allow firms and market operators to benefit from the European "passport" for such business. It is vital that that intention is not compromised by allowing scope for Member States to be super-equivalent which would, in turn,

create further regulatory uncertainty. Therefore, in the case of regulated markets, it is vital that the extension in scope allows all of the products admitted to trading on its markets to be passported across Europe once appropriately approved by its home state regulator – if this is not the case then the benefits of the passport would be lost and we revert back to the current position where we need to secure permission to give companies access to electronic trading screens on a Member State-by-Member State basis.

3) CESR should take care to create a level playing-field between EU markets and those based outside the EU.

The commodities markets are global in their nature and, as well as providing trading venues for derivatives contracts used by global commodity participants, EU markets provide internationally recognised benchmarks in commodities against which a large number of OTC transactions are priced. It is vital that markets based in the EU should be able to freely passport their services across all Member States. However, the application of this freedom should leave European markets at neither a competitive advantage nor disadvantage to similar markets based overseas. CESR should be cognisant of the fact that for all regulated markets offering commodity derivatives, their key competitors are based outside the EU.

Specific comments

Scope of the advice (page 18)

As noted on page 18 of the Consultation Paper, the scope of the definition of “commodity” used in MiFID will impact on a number of other Directives, most notably the Directive 2003/6/EC on insider dealing and market manipulation (‘MAD’). It is important that all of the “derivatives on commodities” admitted to trading on a regulated market or multi-lateral trading facility (‘MTF’) fall within the scope of MAD. This is particularly relevant in relation to the “misuse of information” test within MAD where all commodity derivatives should be subject to equivalent rules. CESR is encouraged to give the term “derivatives on commodities” a broad interpretation when analysing the co-ordination of implementation of MAD at Level 3. In any event, most market operators, including the IPE, will apply the same standards to all of the products admitted to trading on their markets.

Section 3.1(1) Definition of commodity

Questions 2.1 and 2.2. – Should “commodities” for this purpose be limited to goods? Alternatively, should an approach be taken that permits rights or property specifically mentioned in C(10) and other intangibles to be treated as “commodities” as well?

In line with our comments on the Call for Evidence, it is our view that CESR should recommend the adoption of a high-level definition of commodities backed up by a non-exhaustive list of examples. Given the comments and observations made in the Consultation Paper, the approach taken by CESR, which is based around the concept of a fungible good, is appropriate, on the basis that:

- (i) electricity is caught within the definition as part of the tradeable energy complex;
- (ii) an open-ended definition of “intangibles” is used in paragraph C(10) (rather than those products cited in paragraph C(10) being perceived as a definitive list; and

- (iii) where the physically-settled transactions in “intangible” products outlined in paragraph C(10) are traded for investment (i.e. non-commercial) purposes and have the characteristics of other derivative financial instruments – such as being traded on a regulated market or MTF – they should be caught within the scope of the Directive.

Questions 2.3 and 2.4 – Should derivatives based on telecommunications bandwidth be considered to be within the scope of the Directive? If it should be considered within the scope of the Directive, should it be considered to be within the scope of paragraph C(7) or of paragraph C(10) of Annex I?

CESR should advise the Commission to implement an open-ended definition of “intangibles” and therefore, providing that transactions in telecommunications bandwidth meet the tests of investment purpose and having the characteristics of other derivative financial instruments, set out in paragraph C (10), then they should be caught within the scope of the Directive.

Questions 2.5 and 2.6 – If the definition of “commodities” is restricted to goods, should a requirement be imposed that there must be a liquid market in the underlying? If not, should a requirement be imposed that, in addition to being capable of delivery, the underlying must be capable of being traded and if so, should there be a requirement for a liquid market?

The liquidity of the underlying market is, in our view, irrelevant as a test of whether a commodity should fall within the scope of the Directive for a multitude of reasons, *inter alia*, how liquidity should be defined, that certain commodities may be liquid but not freely available and liquidity will change over time. However, it is worth noting that liquidity of the underlying could be relevant when determining whether a derivative on a commodity was suitable for admission to trading on a regulated market or MTF (the difficulties of defining liquidity of course remain).

Comments on Box 2

In relation to the Draft Level 2 advice set out in Box 2, we would make the following comments:

- (i) in relation to the examples of ‘things which would be considered commodities’ in our view while the categories themselves are helpful, the level of detail is too prescriptive and therefore strays too far towards a prescriptive list of commodities. We would therefore recommend the deletion of the ‘such as.....’ elements of the list;
- (ii) this list should be clearly marked as non-exclusive and therefore the brackets around the phrase ‘but not limited to’ should be removed; and
- (iii) there is, in our view, no need to define the term ‘fungible’ and therefore this definition should be deleted.

3.1 ((2) & (3)) Commercial purpose and characteristics of other derivative financial instruments

Question 2.7 – Should there be an initial filter to exclude contracts which are likely to be spot contracts? If so, do you agree with the proposed approach of excluding contracts whose

settlement period does not exceed the lesser of two business days and the generally accepted settlement period in the relevant market?

In line with the view exposed by CESR, we feel that physically-settled spot transactions should fall outside the scope of paragraph C(7). However, as noted in our response to the Call for Evidence, while using a simple test such as delivery within a stated period of time in order to determine whether a transaction is a spot contract has some merits – e.g. it is easy to apply as a rule of thumb – it is our view that such a simplistic measure is inappropriate. Given the wide variety of market practices in commodities, we would suggest that CESR recommends to the Commission a test made around “the period generally accepted in the relevant market as the standard delivery period.”

Other indicative factors

As outlined in the IPE’s response to the Consultation Paper, there are a number of elements which are important for the purposes of defining whether a derivatives contract should be determined to be conducted for a commercial purpose. These include:

- at the time the contract is concluded, the parties contemplate physical delivery (i.e. the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it);
- one or more of the parties is a producer of the commodity or other property, or uses it during the normal course of his business activities;
- the prices, contract size, delivery date or other terms agreed by the parties are unique to that contract or series of contracts; or
- it is not traded on a regulated market or MTF.

In our view, and in response to Questions 2.7 – 2.10, it is important that each of these factors are therefore considered indicative factors in determining whether or not the transaction was entered into for a commercial purpose.

In general terms, and subject to the specific comments set out below, we support CESR’s comments in relation to both third country markets and look-a-like contracts. Please also note the general comments (above) that the Directive should leave EU regulated markets and MTFs at neither a competitive advantage nor disadvantage to similar markets based overseas.

Comments on Box 3

In general terms, and in light of the comments set out above, we welcome CESR’s Draft Level 2 advice relating to commercial purpose. However we would also make the following comments:

- (i) the two business day test in Paragraph (1)(a) should be deleted and should be replaced by a simple test in relation to “the period generally accepted in the relevant market as the standard delivery period”;
- (ii) a test regarding the capacity (or arrangement of capacity) to make or take delivery should be added to Paragraph 3(b); and
- (iii) paragraphs 6 (a) and (b) should be combined to read “it is **admitted to trading – or expressed to be traded** - on a regulated market, an MTF **or a third country market**

considered as equivalent to a regulated market if it complies with equivalent requirements to those established under Title III – even though not traded on that market.”

3.1 (4) Definition of climatic variable, freight rates, emissions allowances, inflation rates and official economic statistics

In our view these terms are self-explanatory and therefore there is no specific need to provide further definitions as to what is caught within these terms. However, where a definition is given elsewhere within European legislation, such as the definition of emissions allowances under Article 3(a) of Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading, then, to the extent that CESR is minded to offer further clarification, this should be consistent.

In relation to derivative contracts relating to emission allowances, the clarification proposed in the draft Level 2 advice in Box 5 in relation to “to emissions allowances that are settled by amendment of the parties’ position on the applicable register of emissions allowances should also be capable of falling within section C(10)” is helpful and should be retained.

3.1 (5) Other categories of assets, rights, obligations, indices and measures

Given the speed with which financial markets develop it is our suggestion that CESR neither perceives the five categories listed in Section C, paragraph (10) as a definitive list of derivatives on intangibles, nor attempts to create such a list. Given the over-arching principle that includes contracts which have the characteristics of other derivatives financial instruments, we believe that any markets which develop in the future will be caught within the scope of the Directive at an appropriate point.

Comments on Box 5

In relation to the Draft Level 2 advice set out in Box 5, we would make the following comments:

- (i) as noted above, we welcome the clarification in relation to derivatives on “emissions allowances that are settled by amendment of the parties’ position on the applicable register of emissions allowances should also be capable of falling within section C(10)” and urge CESR to retain this provision;
- (ii) the list of “other specific categories” should, in our view, be open-ended and flexible enough to adapt to market developments. Therefore, we would recommend that this is a non-exhaustive list of indicative factors. This comment is founded in practicalities as, for example, it is unlikely that in the early stages of market development that historical information referred to in 5(b) would be available. In our view the more pertinent test relate to whether such “intangibles” have the characteristics of other derivative financial instruments as set out below.

3.1 (6) – Characteristics of other derivative financial instruments

Comments on Box 6

In general terms we welcome CESR's interpretation of "characteristics of other derivative financial instruments" and the importance placed on trading on a regulated market or MTF. However, in our view it is important that the following amendments are made to Box 6:

- for the purposes of clarity, it would be helpful to note that all products which are traded on a regulated market and/or an MTF are caught irrespective of the nature of settlement – i.e. this should provide for both cash- and physically- settled contracts. This is vital in ensuring that the passport provided for market operators and MTFs is effective and workable;
- in line with our earlier comments, the list of markets should be expanded to include ***“admitted to trading on a regulated market, an MTF or a third country market considered as equivalent to a regulated market if it complies with equivalent requirements to those established under Title III.”***

Should you have any questions on the materials provided, or wish to discuss these matters further, please do not hesitate to contact me on +44 (0)20 7265 3608 or marc.leppard@theipe.com, or my colleague, Mark Woodward on +44 (0)20 7265 5729 or mark.woodward@theipe.com.

Yours sincerely,

Marc Leppard
Director – Regulation and Compliance

cc. Ted Morris, FSA
Marc Cornelius, FSA
Clive Maxwell, HM Treasury
Laurence Walton, Joint Exchanges Committee
Anthony Belchambers, FOA
Paul Arlman, FESE