International Petroleum Exchange

29 July 2004

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

Dear Mr. Demarigny

Response to CESR's Call for Evidence on the Commission's Formal Request for Technical Advice on Possible Implementing Measures on the Directive on Markets in Financial Instruments (Directive 2004/39/EC)

About the International Petroleum Exchange of London Limited

The International Petroleum Exchange of London Limited ('IPE') 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 five main energy contracts - namely Brent Crude futures and options, Gas Oil futures and options, and Natural Gas futures – and aims to launch UK Power and 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') and welcomes the opportunity to respond to CESR's Call for Evidence. Given the nature of business and concerns of market participants, key areas of specific concern are:

- Article 4 on the List of Financial Instruments (Annex I Section C);
- Article 24 on eligible counterparties; and
- Article 27 on pre-trade transparency.

Please also note that the IPE is a Member of, and has been involved in the drafting of the response by, the Futures and Options Association 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 MTFs) which are physically settled, where those contracts possess the "characteristics of financial instrument s";
- 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 <u>not</u> include physically-settled spot or forward exchange or commodities.

In order to ensure regulatory certainly, it is imperative that CESR's advice does not go beyond the Commission's stated intention without full and proper justification.

2) CESR should follow closely general principles stated by the Commission in preparing Level 2 advice

CESR should take careful account of the principles laid down in paragraph 2.1 of the Mandate, *inter alia*, the principles set out in the Lamfalussy Report. However, we are concerned that there is a clear conflict between the request in the second bullet point of paragraph 2.1 which asks CESR to "respond efficiently to the content of the mandates by providing comprehensive advice on all subject matters covered by the delegated powers included in the relevant comitology provision of the Level 1 Directive, as well as in the relevant Commission request included in the Mandate" and the call in the third bullet point of paragraph 2.3 that "the amount of detail included in the advice should be carefully evaluated case-by-case; the advice should ensure clarity and legal certainty but avoid formulations which would lead to over-prescriptive, excessively detailed legislation, adding undue burdens to the firms and hampering innovation in the field of financial services." In our view there is a severe danger that CESR will feel obliged to provide advice which would be unduly prescriptive or, in practice, would prevent any flexibility at Level 3. Financial markets are, by their very nature, leaders in innovation and creating an inflexible and over-prescriptive regime will only serve to hamper the Commission's

[12] The FSA's Sourcebook defines a "commodity" as "*a physical asset (other than a financial instrument or cash) which is capable of delivery*".

original intention of creating a single market in financial services. CESR should therefore seek to strike a balance between providing enough detail to provide regulatory certainty without providing too much detail and prescription which could prevent innovation.

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, the application of this freedom should not leave these markets at a competitive disadvantage to similar markets based overseas. CESR should take account of the fact that for all regulated markets offering commodity derivatives, their key competitors are based outside the EU.

4) Commend to CESR the benefits of convening a Commodity Derivatives Experts Group.

The Exchange believes that the Call for Evidence is an important but also preliminary element of industry consultation. While acknowledging that it is for CESR to determine its own working methods, the creation of Experts Groups to advise on and contribute to the consultation process is vital to the consultative process. The extension of the Directive on Financial Instruments Markets to include commodity derivatives is perhaps one of the most significant changes to the scope of the Directive and therefore demands careful analysis. We would therefore encourage CESR to convene a meeting of commodity markets experts to discuss issues under the Mandate. The Exchange – amongst others - was involved in such a meeting in the context of the Directive on insider dealing and market manipulation which we understand CESR found extremely useful.

Specific comments

3.1 List of Financial Instruments (Article 4 – Annex I Section C)

The definition of commodity derivatives in Annex 1, Section C is of crucial importance and, in preparing its advice for the Commission, CESR should be guided by the following principles:

- CESR should have regard to the Commission's underlying intention, as outlined above, and ensure that spot and forward physical dealings entered into for commercial purposes, or, if they are not entered into for such purposes, do not otherwise exhibit the "characteristics" of financial instruments, fall outside the scope of the Directive;
- Be alive to the impact of the definition of commodity derivatives in respect of the scope of the European passport provided to regulated markets and investment firms - particularly given that the exemptions in Articles 2(1)(i) and (k) are subject to review under Article 65;
- Care should be taken not to hamper the separate initiatives to liberalise Europe's nascent gas and power markets; and
- Recognise that the definitions of commodity and commodity derivatives are used in a number of other Directives – perhaps most importantly Directive 2003/6/EC on inside information and market manipulation (market abuse) - and be mindful of the consequential implications of the definitions used here.

(1) *A definition of commodity*

It is important that any attempt to define 'commodity' is done in the context of defining commodity derivatives for the purposes of MiFID. As CESR will be aware, within Europe there are active markets in derivatives based on a wide variety of 'commodities', including, for example, sugar, gas oil, tin and live hogs. In defining the term 'commodity' there are two approaches open to CESR:

(i) to present a minimal but wide-ranging definition of commodity such as that prepared by the UK's Financial Services Authority;[2] or

(ii) produce a definitive list of commodities on which derivatives are traded. such as that contained in the US Commodity Exchange Act.[3]

Given the clear and obvious pitfalls in creating and maintaining a detailed list of commodities (the US definition has been amended *ad nauseam* since its introduction), we would urge CESR to present to the Commission a high-level definition. This approach is particularly apposite given the emphasis which should be attached to the definition of derivative and considerations such as the "characteristics of other derivative financial instruments" which should also be used to define the scope of the MiFID.

It is also worth noting that although the UK definition may not be perfect, and does not capture all of the characteristics of a commodity – such as it being a standardised product and the debatable application to electricity – we would commend the UK definition as a reasonable and practical starting point for discussion. Further, some of the difficulties around such a definition are counteracted by the scope of Section C, paragraph (10), which describes in some detail those hybrid contracts, such as derivatives on intangibles such as freight rates and emissions allowances, without direct reference to the term 'commodity'.

(2) *The conditions under which an option, future, swap, forward rate agreement or other derivatives 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*

In our view, 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:

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[3] Under the U.S. Commodity Exchange Act 1922, "*the term "commodity" means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in Public Law 85-839, and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in.*"[3] NB. – on July 18, 1975, the CFTC gave contract market designation to many of the Exchanges which traded previously unregulated commodities, such as oil and gasoline, with the effect that all commodities for which a futures contract was actively traded were brought under federal regulation.

- 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.

One 'test' which is frequently used in determining whether a contract is a 'spot' contract (and therefore deemed to be made for a commercial purpose) is whether, under the terms of the contract, delivery is to be made within a stated period of time – commonly seven days. Whilst such a test has considerable merits, such as being relatively simple to apply, given the wide array of market conventions in the various European commodity derivatives markets, we would recommend that such a simplistic measure is inappropriate.

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

The IPE wishes to make two important points in this regard. Firstly, and of utmost importance, it is also worth noting that Section C, paragraph (6), only refers to "derivative contracts relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF." However, this leaves open the question of whether a physically-settled contract traded on a non-EU exchange, market or trading platform would fall within the scope of MiFID. This is particular relevant for Europe's commodity derivatives exchanges whose main competitors are based in the US or Asia-Pacific region. In light of this we would request that CESR adds to the characteristics an equivalent provision to that embedded in Article 19(6) of MiFID in relation to "a third country market considered as equivalent to a regulated market if it complies with equivalent requirements to those established under Title III."

Secondly, underpinning the definition of commodity derivatives for the purposes of MiFID is the test of whether a contract has the 'characteristics of other derivative financial instruments.' In the Commission's original statement on the scope of the Directive, it is worth noting that "characteristics of financial instruments" were described as: "*inter alia*, they are cleared and settled through a recognised clearing house, give rise to daily margin calls, are priced in reference to regularly published prices, standard lots, delivery dates or standard terms as opposed to the price being specified in individual contracts". In our view this is a suitably representative list of the relative characteristics and therefore it is unfortunate that, for whatever reason, two elements – namely being "cleared and settled through recognised clearing houses or subject to regular margin calls" - have appeared on the face of the Directive. It is important that these criteria are not seen as pre-eminent and that all of the characteristics originally stated by the Commission are given full and proper consideration and, most importantly, equal weight. Central clearing and bilateral margin calls are increasingly used as credible credit risk management techniques in relation to OTC physical transactions which would otherwise not be "characterised" as derivatives. It would be very damaging to the credit risk management of energy participants (particularly given recent credit issues within these markets) if these tests were given undue prominence, especially since it may bring a large number of transactions – and therefore firms - into the scope of MiFID.

(4) The definition of climatic variables, freight rates, emission 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.

(5) Whether there are, at this time, other categories of assets, rights, obligations, indices and measures not otherwise mentioned in Section C, where contracts relating thereto should be determined to fall within Section C.10 CESR should explicitly detail those categories

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. In recent years, there have been initiatives which have sought to create traded markets in, *inter alia*, bandwidth, supply capacity and water. Further, 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.

(6) The conditions (other than cleared and settled through recognised clearing houses, subject to regular margin calls or traded on a Regulated Market or MTF) under which an option, future, swap, forward rate agreement, or other derivative contract relating to the underlying referred to in 4 and, if any, in 5 above, should be determined to have the characteristics of other derivative financial instruments where the contract 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

We would restate our concerns raised in relation to the 'characteristics of other derivative financial instruments' for the purposes of Section C, paragraph (6) as expounded in our response to Question 3 (above) and request CESR to add to the list of conditions an equivalent provision to that embedded in Article 19(6) of MiFID in relation to "a third country market considered as equivalent to a regulated market if it complies with equivalent requirements to those established under Title III."

Subject to that comment, we feel that the conditions noted above – namely that derivative contracts are cleared and settled through recognised clearing houses, subject to regular margin calls or traded on a Regulated Market or MTF – are sufficient.

3.6 Eligible counterparties (Article 24)

The presence of a large number of specialised commodity dealers who may participate in commodity derivatives transactions has already been acknowledged by both CESR and the Commission. Such specialist commodity dealers are enormously knowledgeable in terms of their expertise and understanding of the markets, but do not meet the arbitrary quantitative size thresholds. In such cases the quantitative thresholds should be set accordingly.

3.7 Transparency

As the IPE has repeatedly highlighted, the pre- and post-trade transparency requirements in the Directive relating to regulated markets (Articles 44 and 45) and MTFs (Articles 29 and 30) are restricted in scope to shares admitted to trading. Article 65 provides a review clause concerning the possible extension of the scope of these provisions to transactions in classes of financial instruments other than shares. We would urge CESR, at this stage, to limit its advice to shares admitted to trading on regulated markets and MTFs, and should not be seen to be prejudicing or influencing the outcome of the review envisaged by Article 65 or attempting to lay the framework for extension to other financial instruments.

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,

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