

**Position paper of the Power Exchanges Powernext, EEX and Nord Pool
related to the CESR Meeting on 3rd March on Market Abuse**

This paper summarizes the answers to the CESR questions as given during the Market Abuse meeting on 3rd March in Paris by Powernext, EEX and Nord Pool. It is based on the questions contained in the agenda of the meeting and is given for brainstorming and discussion purposes only.

Preamble: the specificity of commodity derivatives markets

Commodity derivatives markets are different from securities markets

Commodity derivatives markets are a way to transfer risk amongst professionals of the underlying commodity for hedging, arbitrage and speculation purposes. As a consequence:

- They are mainly markets of professionals of the underlying (wholesale producers and consumers), intermediaries who usually do not have assets (banks, financial intermediaries) participate but mainly bring liquidity or speculate, individuals may participate but the markets are not tailored for them,
- As they are not a way to allocate savings to investment, the client money protection principles should be adapted,
- The value of an instrument does not reflect the value of a company but the value of a good,
- The underlying market used to be outside the scope of the financial regulation,
- Most transactions today are made over-the-counter (OTC) outside of the organised exchanges, which are a way to trade amongst others, but transaction volumes in many markets gradually shift towards exchanges
- Organised exchanges provide the reference prices which are then used on the OTC markets by means of indexation. As such, they have a key economical role in their sector.

Commodity derivatives markets are diverse

There are as many types of commodities derivatives markets as commodities:

- There are new and established commodities derivatives markets (eg. electricity vs oil markets):
 - o market practices may exist since decades or may not be established yet
 - o the market participants community can be strong or loose, etc.
- There are local, regional and global markets
 - o Eg. certain metals are traded at a global level whilst some agricultural products such as French potato are local markets.
- Markets are different according to the underlying commodity.
 - o For instance, on the electricity market, as electricity is hardly storeable, hence the closer to maturity, the higher is the volatility. On a day-ahead basis, the observed volatility figures are several hundred percent and on a month-ahead, figures are as high as around 20%. In these circumstances, any information having an impact on price formation may trigger a huge variation in the price of the derivatives instrument and the underlying physical market.

Soundness issues exist and should be treated in a specific way

Market manipulation and insider trading may happen in commodity derivatives markets:

- Insider trading is possible: a market participant can take advantage of an information he knows before the rest of the market and trade on it. The information may be detained by the market participant at first or come to be known by him.
- Market manipulation is possible: a market participant can influence the course of a price as in any market.

The specificity of commodity derivatives markets must however be taken into account:

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- It is because of the nature of commodity derivatives markets that the definitions of insider trading and market manipulation have to be adapted.
 - o Eg.: a market participant must not be accused of insider trading or market manipulation just because he detains sensitive information. Trading upon an information is most of the time legitimate as these are markets for hedging or arbitrage purposes. By nature, a market participant who hedges a physical position has information on its production or consumption capacities.

1. What markets in the EU should we be considering?

Given the structure of the commodity derivatives markets and the scope of the directive, it has been highlighted during the meeting that CESR should consider the regulated markets and MTFs in accordance with the new Investment Services Directive. It is vital for the power exchanges to stress that if the regulation burden on the organised markets is too heavy, there is a risk of flight to safe-harbour, ie participants may choose to trade on the otc markets rather than to comply with the criteria to be met to trade on the regulated markets. Weakening the organised markets would impair their role of providing the reference price in the sector they operate in.

It should also be stressed that improving the soundness of OTC markets is of importance in the commodities markets as, per time, the bulk of trades are made outside of the exchanges.

2. Is there any required disclosure regime in these markets? And who is responsible for setting the regime?

The applicable disclosure regime are:

- The disclosure regime applicable in the underlying physical markets. As commodity derivatives markets are by nature linked to the underlying commodity market, the disclosure regime on the physical market directly benefits trades made on the financial market. The information that has to be known in order to trade on the financial markets is the same information that has to be known on the underlying commercial markets.
- Secondly, the disclosure regime of listed companies that would be applicable to some market participants that are otherwise listed on a EU regulated market. Disclosure made pursuant this regime is however not tailored to the information disclosure requirements of the commodities markets.

The entities in charge of setting the regime are either the financial regulator, the physical regulator or the lawmakers according to the situations.

3. What are the accepted practices regarding disclosure ?

Accepted market practices are rooted in the needs of any financial market but vary according to the specificities of each commodity market.

- Market participants need to know the information that has a significant impact on prices.
 - o This need is a prerequisite as a trade is an anticipation on future price variations. The parallel can be done with securities: to trade an option on a stock, information must be available on the listed company. To trade a derivative on commodity, information must be available on the future generation and transport capacity and demand for this commodity.
 - o This need is universal: information impact the price of an instrument whatever the markets and whatever the status of the participants (professional, intermediaries...). An information is either disclosed or not. There can be no disclosure rule applicable only to the financial markets and not to the physical markets.
 - o Information that has an impact on price is mainly related to production and consumption capacities. This information is structurally detained by market participants and relates to their ability to produce or consume specific goods when this has an impact on prices.

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- Examples of needed information in the electricity market: plant maintenance schedules and plant outages, water levels in hydro-plants, the amount of electricity consumption and the availability of transport capacity etc.
- Market participants expectations on information disclosure may vary:
 - The information to know in order to trade may be comprehensive (eg. from the political situation to the capacities of all market participants) or very precise (eg. the level of reservoirs).
 - It may be reasonable or not to expect information disclosure depending on the specificity of the underlying market. For instance, whilst little can be done on oil as the market is global and production assets out of reach, more can be expected on electricity where there is a EU public policy to implement a sound unified commercial internal market.

A balance is expected between market-reality acceptance and soundness promotion:

- Referring to accepted market practices avoid the risks of over-extending the scope of the directive on market manipulation and insider trading. But it also creates the risk of promoting the status quo and not raising the soundness of markets.
- Example of status quo risks.
 - A market participant to whom the market practice is opposed should not be able to claim that he did not accept the practice which prevents the said practice to be deemed to be an “accepted” practice.
 - In some markets, there is no established market practice of information disclosure yet. Market participants may accept to trade in such circumstances because they have to. This should not be used to claim that there is an accepted market practice because if so, the level of market transparency and soundness will never improve.

Accepted market practice should refer to:

- Disclosure required by law or regulation on the physical market
 - When it exists, a regulation setting the level of disclosure on the commercial market should be considered as the minimum below which market practice cannot go.
- In the absence of sectorial regulation, the reasonable accepted market practice.
 - In order to foster best practice instead of status quo, accepted market practice should be interpreted by reference to the practice that should reasonably be accepted rather than on the observation of the actual practice.
 - This interpretation derives from the public policy objective of the soundness of financial markets. This approach would encourage the establishment of best markets practices without hampering markets where it would be unreasonable to set the disclosure obligation at too high a level. Whilst soundness improvement is out of reach in some markets, it is indeed highly expected in others.
 - For instance, the creation of a sound unified electricity market in Europe together with the creation of a sound unified financial market are two major objectives of the EU for the coming years. As the electricity market in continental Europe is new however, there is no established market practice, in contradiction to the Nordic electricity market. Hence referring to market practices in the electricity derivatives market as they are now would not lead to an improvement of the soundness of the market but would rather make it very difficult for current market participants to trade and for newcomers to enter the market. In this market, “accepted market practice” should refer to the maximum that market participants can expect over the EU.

4. Who is responsible for disclosure? The producers of the commodity, exchanges, anyone else?

The responsibility to disclose should be on the holder of the information, ie. the producer, the grid operator, the consumer or other relevant information holder.

The channels of disclosure may vary:

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- Institutions such as exchanges, grid operators, or even regulators may only be a channel for information disclosure. It has to be stressed that such channels can disclose information only if they have the power to do so. This power can stem from:
 - o a regulation that obliges the holder of the information to disclose it through a specific channel or
 - o market consensus whereby all market participants agree to disclose information through a certain channel.
- For instance, in the electricity sector, continental exchanges that are not designated by law as the unique channel do not have the power to impose such disclosure. Requesting them to do so would be too heavy a burden. In the Nordic electricity market (covering Denmark, Finland, Norway and Sweden) however, the situation is different where market transparency is established for the exchange trading activity as well as for the reported OTC trades for clearing following regulation of national law. Further, there is also a consensus with the market participants that in order to have confidence in an electricity derivatives market, price sensitive information is to be disclosed to the Nord Pool exchange in an equal manner and published on the Nord Pool website (see separate document from Nord Pool to CESR for further details).

5. **What kind and type of disclosure is required? Transaction information, information regarding the underlying asset, other?**

There are different kinds and types of information disclosure.

- Information on transactions and quotations in electricity derivatives are detained by the market operator (the exchange) and have to be disclosed by the market operator (exchange) in an anonymous fashion for the market to be transparent.
- Information of electricity capacities and changes of such capacities, that market participants have to know in order to trade, have to be disclosed by producers, consumers, transmission system operators or others according to specific situations.

6. **Is disclosure required on a regular or an adhoc basis and through what channels is disclosure made?**

Some information should be disclosed on a regular basis whilst other on an adhoc basis.

- The parallel can be made with listed companies. For market participants to be able to trade stocks, the holder of the information – the issuers – must disclose information on a regular basis (P&L, results, etc) and on an adhoc basis (any news that would have a significant impact on prices). The same is true for commodity derivatives markets.
- For example, in the electricity sector, adhoc information would relate to sudden changes in the generation capacity that would have a significant impact on prices given the volatility of the markets.

As stated in answer to question 4, the channel of disclosure may vary amongst the markets.

7. **Are the above answers affected by the nature of the underlying asset? For example, there are underlying assets that are not even tangible (e.g. weather) or not yet produced. What happens in situations like these?**

Yes. There are potentially as many rules as commodities markets. The impact of the non-storability of electricity has already been discussed on the first page of this document.

8. **Who is the competent authority in these markets?**

The competent authorities in these markets are the financial regulators and the statutory authorities that can issue sectorial regulation. The latter can be either sectorial regulators or in the absence of them the law and regulation makers.

In Germany the electricity exchange is supervised by the exchange supervision of the Ministry of Economic affairs of the respective Land with respect to the German Exchange Act and the exchanges rules and regulations. Financial trading is being supervised by BaFin with respect to market manipulation. The

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current German Securities Trading Act does not foresee insider trading related issues for commodity derivatives.