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## CDWG response to EC Communication on Derivatives

### 1 Introductory comments

This evidence represents the views jointly held by the members of ISDA, the FOA and EFET. These organizations have been cooperating as part of the ‘Commodity Derivatives Working Group’ (CDWG), with the aim of drafting this joint response. This working group, together with the Commodity Firms Regulatory Capital Working Group (CFRC WG), which was set up to discuss the prudential treatment of commodity firms in the EU, provides an international industry platform for discussing the regulatory treatment of commodities and commodity firms active in the EU. The members of the association working groups are mainly risk officers, compliance officers, and lawyers from major commodity firms active in the EU, with expertise in the field of credit, market or operational risk.

*Where we use the term ‘CDWG’ in this submission, we are referring to the view jointly held by the commodity market participants of each of these associations regarding the consultation paper.*

ISDA represents participants in the privately negotiated derivatives industry and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

The FOA is the industry association for 160 international firms and institutions which engage in the carrying on of derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector.

EFET works to promote the development of a sustainable and liquid European wholesale market in electricity and gas, as well as in related physical commodities and derivative contracts. EFET is complementary to existing industry organizations in Europe as it is solely dedicated to energy trading issues, and lists over 100 firms as members.

The Commodity Derivatives Working Group (CDWG) welcomes the opportunity to comment on the European Commission's consultation on 'Possible initiatives to enhance the resilience of OTC Derivatives Markets', published alongside a Communication and staff working paper on the same theme on 7 July.

Officials in the Directorate-General for the Internal Market will be familiar with the views of the CDWG on a number of issues highlighted in the consultation document, notably in respect of transparency and central counterparty clearing. CDWG members had an opportunity to share their views on issues around central clearing of commodity derivatives in a meeting with the European Commission, also involving a wide range of financial market participants, in April 2009, and in a letter submitted to the European Commission on 29 May 2009.

The CDWG would like to commend the European Commission on the detailed understanding of the commodity derivatives markets that it built up in the process of drafting the three documents mentioned above, but reflected in particular in the staff working paper. Key observations in this paper included that:

- *“A significant number of participants in these markets are not financial firms, but commercial producers hedging their price risks. Therefore, legislation designed for the financial sector may not be adequately tailored to their activity and risk profile. Indeed, this is reflected in a number of exemptions from EU financial legislation, such as MiFID and CRD. Ensuring access of such firms to commodity derivative markets is important as it supports building competition within the recently liberalised EU commodity markets (e.g. electricity and gas). It also contributes to market liquidity.”*
- *“Commodity derivatives are extremely varied and diverse. The market structure differs depending on segment, with some being more standardised and subject to CCP clearing, with others being pure OTC. The diversity of the various market segments and the broad range of actors involved reduce the amount of systemic risk but make it difficult to gather centralised market information and equally present challenges in terms of standardisation.”*
- *“There are inherent limitations to CCP uptake in markets as diverse as commodities and bilateral clearing can accordingly be expected to continue and even extend as regards coverage.”*
- *“counterparties in commodity derivatives are non-financial firms and as such less accustomed to collateral or exempt from collateral provisioning. Moreover, collateral provisioning is complemented for physical trades that are not marked-to-market by other sorts of assurances, such as parent company guarantees, pledge of assets, prepayments or letters of credit.”*

The CDWG agrees with all of the above statements.

## **2 CDWG key messages concerning the EC consultation on ‘Possible initiatives to enhance the resilience of OTC Derivatives Markets’**

The CDWG supports efforts to strengthen the regulatory framework for OTC derivatives where there are clearly identifiable market failures that can only be remedied by regulatory intervention. Any changes to the regulatory framework should focus on:

- Mitigating risks to the financial system – inappropriate or disproportionate regulation of commodity derivatives markets poses real risks to the real economy;
- Providing appropriate levels of transparency to ensure effective price discovery and enhance liquidity;
- Providing regulators with the necessary tools and information to ensure effective oversight of markets and market participants, and in particular, to detect abusive or manipulative practices; and
- Promoting greater cooperation and understanding between regulators, whilst respecting differing regulatory regimes

### **3 CDWG remarks on central clearing, standardization, supervision and transparency in commodity derivative markets**

There are a number of other points which the CDWG would like to make on central clearing and standardization specifically before it addresses the 24 questions put to industry by the European Commission in its consultation paper. A number of these points were also made in our paper submitted to the European Commission on 29 May 2009.

*(a) Central clearing is already in wide use in commodity derivative markets and will become increasingly prevalent in the coming years as a result of market-led initiatives.*

Exchanges, alternative trading platforms and clearing houses have shown themselves to be adept in recent years at developing products meeting commodity market needs, including the need to limit counterparty risk efficiently.

These initiatives have proved successful for commodity derivative contracts where sufficient standardization and liquidity is in evidence to facilitate central clearing. However, as stated by the European Commission, *“there are inherent limitations to CCP uptake in markets as diverse as commodities and bilateral clearing can accordingly be expected to continue and even extend as regards coverage.”*

*(b) No financial systemic risk requiring a regulatory push of OTC commodity derivatives contracts (to which commodity firms are counterparties) onto clearing house is apparent for commodity firms.*

The European Commission’s staff working paper recognises that commodity firms’ activities and risk profiles differ significantly from those of financial institutions therefore warranting different treatment in financial regulation. CEBS and CESR have recognized that these risks “appear in general to be lower than the systemic risks and externalities” associated with financial institutions. Many specialist commodity firms (depending on the precise nature of their trading and counterparties) currently benefit from exemptions from MIFID and CRD – meaning that exempted commodity firms are not required to hold regulatory capital under EU legislation, for credit, market and operational risks.

Commodity firms have not contributed to the causation of the financial crisis and have not suffered losses in the range suffered by financial institutions – even as commodity prices have fallen in the wake of lower global demand. No “web of mutual dependence that was hard to understand”, as referred to in the European Commission’s consultation paper, exists in commodity derivatives markets.

Commodity derivatives are primarily used as a means for hedging and limiting price risk exposures. Typically commodity firms run flat or close to flat books when looked at in total, considering exposures resulting from physical supply and demand side activities and their hedging programmes.

We do not believe that there is a risk-based case of market failure to justify the regulatory movement of OTC commodity derivatives on a grand scale onto CCPs. Indeed, as explained above, the commodity market is already evolving to manage risks efficiently and effectively – and should be allowed to continue to evolve in the absence of market failure.

***(c) What is right for one type of OTC derivative market may not be right for the commodity derivatives markets***

We welcome the European Commission's acknowledgment of the major differences between different OTC derivative markets, in particular in its staff working paper. Characteristics such as levels of standardization and customization, diversity of market participants and fragmentation and liquidity in each market need to be considered. No single regulatory solution is likely to be appropriate for all markets.

The CDS market has been seen by regulators as a priority focus in terms of establishing central clearing services. There are a number of factors which made a central clearing solution appropriate to CDS markets, which do not apply, in our view, to commodity markets:<sup>1</sup>

- Prior to the initiatives launched in recent months (against a background of regulator-industry discussions), credit default swaps were not being centrally cleared; there are, as mentioned, a number of existing market-led initiatives to clear OTC commodity derivatives.
- The credit default swaps market is a market where financial institutions make up a large part of the market, acting as dealers; The OTC commodity derivatives market is comprised of a wide variety of actors, ranging from large oil companies to local municipalities, corporates, specialist energy traders and financial institutions and investment firms and is not dominated by dealers and financial institutions in the same way as the CDS market.
- Credit default swaps are very standardised at the more liquid end of the market (e.g. index trades), and thus central clearing is operationally more feasible; The OTC commodity derivative market is not homogenous – it is rather comprised of many different underlyings and local markets, with further diversity apparent through different types of documentation and methods of settlement.

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<sup>1</sup> See for a comprehensive overview of commodity markets: Mandate to ESME for Advice («ESME-Advice»), Review under Articles 65(3)(a), (b) and (d) of the MiFID and 48(2) of the CAD and proposed guidelines to be adopted under the Third Energy Package, pages 11 - 44; see: [http://ec.europa.eu/internal\\_market/securities/docs/esme/commodity\\_derivatives\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/esme/commodity_derivatives_en.pdf)

***(d) Mandatory or incentivised central clearing for OTC commodity derivatives implies significant costs that outweigh potential benefits***

Commodity firms, while currently direct participants in commodity derivative markets are not typically CCP clearing members (with the occasional exception). Members of clearing houses are typically credit institutions or regulated investment firms. Thus, a regulatory push towards central clearing of commodity derivatives would either

- (a) require commodity firms to pay considerable amounts in initial and ongoing margin to be members of central counterparties; or
- (b) more likely, require commodity firms to pay financial institutions for clearing services at central counterparties.

‘Incentivisation’ of central clearing through capital rules, or requirements to post more collateral in relation to bilateral, non-clearable contracts, would also imply higher costs linked to sound practices which are themselves designed to limit risk.

We do not believe that there is any evidence of market failure in commodity derivatives justifying such steps. The commodity derivatives market has shown that is flexible and capable of developing efficient and effective solutions for dealing with credit risks, and should be allowed to continue to develop in this respect. If not allowed to do so, there is a significant risk that unnecessary (and costly) regulatory solutions may serve to create barriers to entry to the market, in particular for smaller potential market participants.

This would undermine efforts to develop a single EU competitive energy market, and Europe’s ability to produce sufficient energy (see point (e)).

***(e) OTC commodity derivatives are designed to reduce risk in commodity markets; excessive regulatory-driven standardization and mandating or incentivisation of central clearing could actually increase risk and undermine the development of commodity markets.***

Commodity derivative markets have developed out of a need by commercial producers and users of commodities to manage their exposure to price risk.

The CDWG is not opposed to standardisation in terms of e.g. legal practices, or transaction processing. Indeed, organizations like ISDA and EFET have facilitated legal certainty in commodity derivative markets through their work on legal documentation. However, regulatory measures can have the unintended consequence of creating barriers to entry which can impact particularly on smaller players and inhibit development of liquidity/competition.

The CDWG understands that the European Commission sees standardization of contracts as a means for facilitation of central clearing efforts. However commodity firms caution that a risk-focused drive to standardize products (at the expense of the ability to customise), for any purpose, could be counter-productive as it would:

- Undermine the EU drive towards more competitive and self-sufficient energy markets. The ability to customize products according to the risk management needs of innovative new market entrants and customers in general allows these market actors to have the confidence to invest in their business, with long-term benefits for Europe's productive capacity.
  - Actually increase risk, as commodity market participants seeking to mitigate specific risks through tailor made transactions would either find standardized contracts could not adequately cover such risks or would do so at a prohibitive cost. For example, product standardization could restrict hedging optionalities, only allowing certain amounts, dates or rates to be traded. Companies with modest treasury resources could be put off hedging in this way or may choose not to participate in the market, increasing volatility and commercial risk and damaging competition and liquidity. This does not seem appropriate in the post-crisis environment.
  - Incentivise dealers not to offer those kinds of contracts and/or increase their cost where available;
  - Have unhelpful effects on companies' balance sheets: standardized contracts make it extremely difficult for commodity firms to satisfy hedge-effectiveness tests required under international accounting standards (e.g. FAS 133/IAS 39). Companies not qualifying for hedge-accounting would face higher profit & loss volatility. In addition, proper cash-flow hedging for non-financial companies would become very difficult, as hedge transactions would require immediate cash-flow, creating a mismatch with the timing of the cash-flow being hedged and creating serious cash-flow difficulties. This is even more severe in certain energy markets where long-term-contracts and high volatilities are typical. Best practice in treasury management has always discouraged hedging a lower term cash-flow by rolling forward a short-term contract that generates short term cash-flows.
  - Simply replace credit risk with liquidity risk. Daily margining, would not only create considerable administrative challenges (daily mark-to-market valuation and daily margining; collateral in cash not in assets), but also force to use valuable credit lines to draw down cash needed. Systemically, risk would not have been reduced: instead of a credit exposure to a commodity-swap, the banking sector would be left with credit exposure on a loan.
  - Discourage industry from pursuing continued standardization of processes (with a view to reducing operational risk also for structured products), if commodity market participants feel that it will allow regulators to force them into use of central clearing services.
- (f) *The CDWG supports international regulatory cooperation and drafting legislation with an extra-territorial impact*

Under the proposals for derivatives markets recently released by the US Treasury, many commodity firms which (for good reason) benefit from exemptions at EU level for prudential and conduct of business regulation in the CRD and MIFID could be faced with aggregated position limits, requirements to hold prohibitive amounts of regulatory capital, and a requirement to centrally clear transactions that should not otherwise be centrally cleared.

The US administration has stated that it expects other major regulatory jurisdictions to adopt equivalent requirements, in order to prevent a ‘race to the bottom’ in regulation.

The European Commission is aware of the reasoning behind the exemptions from MIFID and CRD, and that no case has yet been made sufficiently to justify imposition at EU level of prudential capital requirements, in particular, on specialist commodity firms (CESR and CEBS have, as mentioned, concluded that commodity firms are associated with lower systemic risks and externalities than financial institutions).

While commodity firms support international regulatory coherence, they do not feel that this should come at the expense of imposing disproportionate and harmful regulation, subject to insufficient cost-benefit and impact analysis, and which could lead to significant unintended consequences in terms of participation and liquidity in commodity markets, and, in turn, the real economy.

***(g) The CDWG supports regulatory access to transactional data (in gas and power markets, through record keeping) – and supports greater transparency for OTC commodity derivative transactions cleared or transacted at central infrastructures, and concerning supply conditions in physical markets***

The CDWG supports retention of data in commodity markets for periods of up to 5 years, so that regulators can access this data on request, as documented in submissions made in relation to the EU regulatory review of the wholesale electricity and gas market trading. We believe that this should be sufficient for the supervisory needs of regulators – allowing them to access this data where they believe wrong-doing is suspected.

Many CDWG member firms have also maintained a close dialogue with their regulators during the financial crisis, keeping them informed as to their general financial well-being, and of any significant risks they face in commodity derivatives markets.

CDWG member firms caution against the imposition of burdensome transaction reporting requirements modelled on transaction reporting methodologies in other financial markets. These would imply significant investment in IT infrastructure with little benefit for regulators. The negative impact of such requirements would be further exacerbated by duplicative or overlapping transaction reporting requirements in different jurisdictions.

The development of trade data repositories may provide benefits in terms of transparency of transaction data. However, it is not clear that such a solution should be imposed through

regulation as there is no evidence that the commodity derivatives market cannot respond to the need to deliver appropriate transparency in respect of concluded transactions. The CDWG believes that a significant step in achieving this would be to require all operators of regulated exchanges and MTFs and brokers to publish concluded/cleared (and clearable) standardized transactions that are traded through them on an aggregated / anonymous information– possibly subject to guidelines on the nature, content and timing of publication.

We would like to add that there are many commercial data providers that already provide trade information to the market. If improvements can be made to the provision of information by exchanges, clearers, MTFs, brokers etc, this would be another important step towards effective transparency in wholesale commodity markets.

We would question whether either regulatory or ‘societal’ interests are served by requiring either regular reporting to regulators or publication of details on bespoke bilateral transactions that cannot be transacted at the infrastructures mentioned above. Record keeping obligations means regulators can access such information on request and their very nature means they cannot be included in any standardized transparency regime.

Lastly, we believe that in physical commodity markets regulators may be best served by focusing on improving transparency in both fundamental data and also that which is necessary for efficient and effective access to key infrastructure. Considerations in this context have recently been undertaken by CESR and ERGEG in their review of transparency and transaction reporting issues (as noted in the EC staff working paper published along with the EC consultation on Derivatives).

## **4 Answers to questions in Consultation Paper**

### **2. PROMOTING FURTHER STANDARDISATION**

#### **(1) What would be a valid reason not to use electronic means as a tool for contracts standardisation?**

The CDWG believes that basic distinctions between standardization of processes, standard-agreements, etc. (ISDA, EFET, etc.) and the standardization of products need to be made; While standardization of processes may be somewhat welcome, standardization of products would, in risk mitigation terms, be counter-productive.

Concerning standardization of processes, it is worth recalling that appropriate industry solutions already exist e.g. the ICE clearing house eConfirm system, and the initiative by EFET to increase operational efficiency and facilitate clearing through EFETnet via electronic confirmation matching (eCM), electronic Position Matching (ePM) and electronic Settlement Matching (eSM) and its work with clearing houses, brokers, exchange, GCMs and traders to automate the flow of trades into clearing by removing proprietary procedures and IT interfaces.

In principle, there are valid reasons to standardize process ‘electronically’.

The benefits of standardisation and automation may be reflected in cost reductions, process improvement and mitigation of operational risk:

- Process improvement
  - Standard processes across the community, reducing operational complexity
  - Ease of market access for new entrants
  - Opportunity to standardise other spin-off areas such as product names etc.
  - Scalability - there is a general market trend towards increased clearing with volumes ‘doubling every 2 years’.
- Cost reductions
  - Registration work load including issue resolution; this is estimated at a 25% reduction in workload compared with the current process

Benefits specific to different roles include:

- For traders
  - Removal of operational barriers to clearing
  - Reconciliation of margining and mitigation of related operational risk
  - Reduced overheads of dealing with clearing service providers
- For exchanges:/clearing houses
  - Increased volume in clearing (both Exchange and OTC)

- Increased customer satisfaction
- Market development and competitive advantage
- Channel for exchanging other data (i.e. MiFiD)
- For brokers
  - Reduction in operational risk
    - Removes risk associated with the give up process (i.e. being left as a counterparty to a trade)
    - Multiple mechanisms simplified
  - Increased execution volumes
  - Time reduction of the clearing registration process

While the benefits of standardization of processes are clear, in particular concerning operational risk reduction, we warn that viewing standardization as a tool to enforce central clearing will simply disincentive commodity firms' pursuit of these operational improvements, as they are needed for structured products as well.

In addition, requiring smaller market participants (large consumers, municipalities), dealing in lower volumes, and transacting contracts less frequently, to invest in IT systems in this context would impose a heavy compliance burden, with little benefit in terms of mitigation of systemic risk. These market participants play an important role in commodity markets, and must not be discouraged from participation by such burdensome requirements.

The commodity derivatives market is a very diverse one (or rather a series of highly diverse markets) in terms of the types of market participants, and the diverse, often highly bespoke nature of commodity derivative contracts. This makes 'electronification' more challenging. We welcome the European Commission's recognition of this point in its staff working paper:

*“The lack of standardisation and the wide diversity of players active in the market present particular challenges as regard the broad uptake of automated trade confirmation services”.*

We believe that independent cost-benefit analysis should be deployed, taking account of the concerns of all market participants, and the motivation and nature of their involvement in privately-negotiated derivatives contracts, if a regulatory requirement for process automation (including commodity firms in-scope) is to be considered.

**(2) Should contracts standardisation be measured by the level of process automation?  
What other indicators can be used?**

Standardization is a concept that needs further definition in this context.

We also believe that there should not be an assumption that standardization in *product* terms is desirable in every privately negotiated derivatives market, for every type of contract in these markets. The European Commission is aware that for many market participants in commodity

derivatives markets, it is the ability to customize contracts according to the specifications of particular counterparties that make them most useful.

We understand that process automation is one measure of process standardization. To the extent that standardization is eventually deemed a desirable outcome for specific commodity derivative markets and market participants, and standardization is deemed to be enhanced by greater process automation, one measure of standardization could be levels of process automation.

It is worth recalling that standardization is not the sole facilitator of central clearing: market liquidity should be a prerequisite (for the purpose of margining and pricing of the relevant contracts).

### **(3) Should non-standardised contracts face higher capital charges for operational risk?**

Many specialist commodity firms (depending on their corporate structure and the nature of their trading activities and counterparties) are exempt from CRD and MIFID and should not therefore face any capital charges for use of standardized or non-standardized contracts.

Higher capital charges on contracts that are ill-suited to central clearing would simply (i) disincentivise market participants from using them and (ii) make their use more expensive. This would damage Europe's energy production and supply capacity, market participants feeling discouraged from making major investments by an inability to hedge the commercial risks they face in an economical or efficient manner – contradicting the development of single EU competitive energy market.

The CDWG understands that standardization is viewed by the European Commission as a prerequisite for central clearing of OTC derivatives. A growing part of the commodity derivatives markets is already centrally cleared, and this trend is likely to continue, without the intervention of regulators.

### **(4) What other incentives toward standardisation could be used, especially for non-credit institutions?**

Please see above.

Standardization of commodity derivative products is not sought by market participants. Customised contracts are sought by customers due to the specific features of the energy business where demand and supply need to meet: contractual flexibility is necessary to fulfil this requirement.

Reduction of operational risk charges on standardized (in process terms) OTC commodity derivative transactions, while maintaining existing charges on e.g. non-standardized (e.g. paper confirmed) transactions would incentivise electronic processing, reducing operational risk, and allow commodity firms more capital to invest in supply and production.

CDWG members believe that an effective and proportionate approach to incentivisation of central clearing would be to review the commercial conditions associated with use of central clearing houses, including those costs associated with access to central clearing services e.g. registration, membership, transaction, clearing and delivery fees, whereby the free choice of clearing will imply that market mechanisms will incentivise central clearing in case competitive solutions are offered. The European Commission could also examine whether CCPs should have client money protection rules in place to ensure clearing takes place on a sound and competitive basis.

### **3. STRENGTHENING BILATERAL COLLATERAL MANAGEMENT FOR NON-CCP ELIGIBLE OTC DERIVATIVES**

#### **(5) How could the coverage of collateralised credit exposures be improved?**

In general, commodity firms do not believe there is any evidence of market or regulatory failure in commodity markets – and no clear case has yet been made for regulatory intervention insisting on higher bilateral collateral coverage in commodity derivative markets.

The European Commission (in its staff working paper) has noted that collateral is not the only type of risk mitigant used in OTC commodity derivatives trading, referring to parent company guarantees, pledge of assets, prepayments or letters of credit in relation to physical trades, for example.

CDWG commodity firms (via the Commodity Firms Regulatory Capital Working Group, which is a sub-group of the CDWG and shares the same membership), have also made the case, in the context of the EC review of the exemptions from the CRD and MIFID for commodity firms that are regulated under MIFID, for an ‘Alternative Approach’ to risk management based on existing and proven risk management practices in the commodity trading sphere, and relevant (for the commodity industry) disclosure requirements based on those required under IFRS. This approach, combined with the recognition of alternative forms of risk mitigant beyond collateral, provides a sound alternative for commodity firms.

The CDWG also supports the adoption of a Netting Directive, which would ensure more legal certainty in the market and complement and enhance the effectiveness of bilateral collateral management as a risk mitigant.

#### **(6) Are there markets where daily valuation, exchange of collateral and portfolio reconciliation cannot be the goal? Please justify.**

Where commodity firms have entered into trades to hedge supply and demand commitments, the requirement to meet collateral calls from potential extreme swings in prices places significant liquidity demands on a company. Many companies manage a prudent financial management policy, including a strong credit rating in order to reduce collateral demands by negotiating with counterparties levels of unsecured mark to market exposure before collateral calls are required. It would not be equitable if those companies which have an increased cost of capital from

managing a prudent balance sheet/strong credit rating were unable to benefit from using this strong credit rating to negotiate higher levels of unsecured limit and therefore a reduction in the need for liquidity facilities to meet potential collateral calls.

Requiring a significantly higher level of collateralisation in bilateral contracts would, we believe, come at the expense of liquidity, and would imply an high regulatory burden unsuited to many of the types of counterparty, especially consumers, active in these markets. It would also divert money that could otherwise be used to invest in production capacity, across all commodity sectors.

**(7) How frequently should multilateral netting be used?**

CDWG member associations support the adoption of a Netting Directive at EU level, ensuring legal certainty in cases of close-out, and including a wide scope of counterparties active in commodity derivative markets. We note that the European Parliament called for this step in 2007 in its report on the EU White Paper on financial services 2005-2010.

Netting is a key part of any prudent credit risk management programme, and the use of Master Agreements has increased significantly in recent years. The widespread use of these Agreements (e.g. the ISDA and EFET Agreements) played an important role in limiting the impact of e.g. the Lehman Brothers and Enron collapse and withdrawal from the market of TXU.

This question may refer to trade compressions. If so, we would highlight that trade compression is most easily undertaken in highly liquid and standardized markets. The more bespoke, customized nature of commodity derivative markets may not so easily lend itself to trade compressions.

**(8) Should bilateral collateral management be left to self-regulatory initiatives or does it need to be incentivised by appropriate legislative instruments?**

Again, we underline that we support the adoption of a Netting Directive addressing close-out in cases of insolvency of counterparties – this would greatly ensure legal certainty, and reduce counterparty risk on a harmonized EU basis.

We believe that any legislative instruments that the European Commission may consider in this context should be developed with the specificities of different derivative asset classes in mind, and the nature of the different participants in these markets.

**4. CENTRAL DATA REPOSITORIES**

**(9) Are there market segments for which a central data repository is not necessary or desirable?**

We are not aware of any major regulatory drive toward mandatory or voluntary use of data repositories in the commodity derivatives sector and we do not consider that a compulsory central data repository is needed.

Commodity firms are concerned about the potential burdens (similar to those associated with transaction reporting) that could fall on them as a result of the establishment of trade repositories, especially if multiple trade repositories are established.

No systemic risk-based case has been made for the establishment of trade repositories in the commodity derivatives market.

The CDWG has stated its support for retention (for 5 years) of transaction data by commodity firms in the wholesale electricity and gas markets, to be provided to regulators on request (the so-called “record keeping” provision in the 3<sup>rd</sup> package).

**(10) Which regulatory requirements should central data repositories be subject to?**

No comment.

**(11) What information should be disclosed to the public?**

As mentioned, the CDWG does not yet believe that a clear case has yet been made for the establishment of a central data repository, and is concerned that the costs (to the market) of such an initiative (or initiatives) would outweigh the benefits (in systemic risk terms).

The CDWG would not support the disclosure to the public of information held by a possible central data repository. Such information would be commercially-sensitive and should only be used by regulators for supervisory and market oversight purposes. In particular in EU energy markets a sufficient degree of trade transparency through the trading platforms is present (e.g. [www.eex.de](http://www.eex.de))

Notwithstanding concerns regarding commercial sensitivity, the public disclosure, for example through commitment of traders reports, of information held within data repositories would be of little value to the public and risks providing a misleading picture of either an individual firm’s exposures or the wider market.

As we highlight in response to Question 21, the CDWG strongly believes market efficiency and integrity is best served through the targeted application of post-trade transparency requirements for those standardized contracts that are capable of being traded on organized trading platforms.

**5. MOVE CLEARING OF STANDARDIZED OTC DERIVATIVES TO CCPs**

**(12) Do you agree that the eligibility of contracts should be left to CCPs? Which governance arrangements might be necessary for this decision to be left to the CCPs' risk committees?**

Central clearing is a welcome additional risk mitigation tool for market participants (along with the many existing risk mitigation tools for bilateral commodity derivative contracts which have proven successful). The CDWG stresses, however, that it should be left to market participants to decide if, how and where they clear their commodity derivative transactions. CDWG firms do not believe that a decision by a CCP that a contract is eligible for central clearing should mean that they have to clear this contract at a CCP. No risk-based case pertaining to any market failure in commodity derivative markets, nor among commodity firms has yet been made which would justify such a requirement

In deciding what contracts are eligible for CCP clearing, users/counterparties in cleared transactions should have a major role, probably via the risk committee of the clearing organization. For-profit CCPs need a check; eligibility being decided solely according to whether or not the CCP will clear the product implies a clear conflict of interest (which could inter alia compromise the soundness of a CCP).

**(13) What additional benefits should the CCP provide to secure a broader use of its services?**

Additional benefits that CCPs could provide include regulatory reporting and post-trade transparency services.

Electronic processing services linked to clearing houses would also be a useful tool for the market (e.g. the ICE eConfirm service).

There would some value in users of central clearing services taking economic stakes in the capital of clearing houses, benefiting commodity firm user-shareholders (and incentivising use of CCPs, where possible, by these firms).

**(14) Is the zero-risk weighting a sufficiently effective incentive for using CCPs across different market segments?**

EU Capital Requirements Directive rules do not apply to certain specialist commodity firms that benefit from exemptions from MIFID and CRD (depending on the nature of their trading and counterparties).

The CDWG believes that regulators should consider the nature of different OTC derivative market participants and the nature of the risks they incur (or don't incur), in considering what incentives should apply in each case. In this regard, the CDWG welcomes the recognition in the European Commission's staff working paper that "*legislation designed for the financial sector may not be adequately tailored to their (commodity firms') activity and risk profile.*"

Imposing high capital requirements on bilaterally cleared commodity derivatives contracts would simply divert capital away from investment in Europe's supply capacity, in conflict with Europe's 2nd Energy review goals.

**(15) Should additional requirements, such as appropriate account segregation, be introduced to apply the zero-risk weighting to indirect participants?**

The CDWG has addressed the relevancy of zero-risk weighting in the previous question. In general, CDWG members welcome account segregation for client funds at clearing houses, and encourage regulatory promotion of this concept.

**(16) Should bilateral clearing of CCP-eligible CDS be penalised and, if so, to what extent? Is there a need to extend regulatory incentives to clear through a CCP to other derivatives products?**

The CDWG does not feel that the question concerning CDS is relevant to the commodity firms making up its membership.

The CDWG strongly opposes the use of capital requirements to incentivise central clearing by its members. A free choice of credit risk management instrument should remain the norm for commodity firms.

Irrespective of ideas designed to incentivise central clearing, in many cases, central clearing is not possible or desirable. Factors to consider here include

- High levels of customization of contracts;
- Insufficient liquidity in the relevant markets or market segments;
- (linked to the above) infrequent trading of contracts, making it challenging to calculate margin requirements; and
- A high presence of commercial users of these contracts that would not typically be members of clearing houses, and who, for this bespoke end of the market, see little justification in the extra cost implied by central clearing when these contracts are themselves designed to mitigate commercial risk.

In the above cases, it would seem disproportionate for any market participant to be penalised for not using a CCP. Such a requirement would simply divert capital away from investment in Europe's supply capacity, in conflict with Europe's 2nd Energy review goals.

CDWG members would prefer to explore with the European Commission whether it could see means through which commodity firms' use of CCPs could be placed on a sound (through client fund segregation), competitive (ensuring free choice of clearer) and efficient (through facilitation of direct access to clearing services) basis – thereby encouraging take-up of these services. The CDWG notes, on this last point, that allowing direct membership of commodity firms to clearing houses would also lessen concentration of risk in financial institutions acting as clearing members.

Another mean to incentivise central clearing in the energy sector would be to allow a more diverse range of acceptable collateral, possibly including CO2 certificates and, in limited cases,

guarantees from non-financial parent companies deemed isolated from any systemic risk to the financial sector.

**(17) Under which conditions should exemptions be granted and by whom?**

The CDWG understands this question to refer to the conditions under which bilateral clearing of CCP-eligible CDS may be permitted and so is of limited relevance to CDWG members. However, as indicated in our response to Question 16 above, it is essential that commodity firms retain flexibility and choice in terms of how they manage counterparty credit risk.

Notwithstanding the existence of the exemptions for commodity firms contained in the Capital Requirements Directive and MiFID, the CDWG believes it would be wholly inappropriate to penalize firms through increased regulatory capital for using risk mitigation techniques other than centralized clearing. A key feature of commodity derivatives markets is the ability of participants to use their underlying physical assets as collateral. For those pledging collateral, this frees up vital liquidity for investment in production and supply infrastructure, whilst for those receiving such collateral, their exposure moves in the same direction as the value of the collateral or overall business of the counterparty.

**(18) What is the minimum acceptable ratio of CCP cleared/eligible contract? What is the maximum acceptable number of non-eligible contracts?**

We do not believe that there is any risk basis for applying such a ratio to wholesale commodity trading business.

**(19) What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?**

As previously stated, the CDWG believes that regulators should have access to transactional data through the record-keeping obligation of firms so as to enable them to discharge their supervisory functions effectively. The CDWG would question the need for and value of additional mandatory regimes and would strongly caution against imposing additional burdens on commodity firms in this regard. See also our responses to questions 21 and 22.

**(20) How could European legislation help ensuring safety, soundness and a level playing field between CCPs?**

The CDWG believes that standards addressing CCPs should ensure:

- They are managed on a sound basis, according to clear rules on important aspects of their risk management systems, including use of collateral, margining, stress testing, guarantee funds etc;
- Fair, transparent pricing for central clearing services;

- Unbundling of services;
- Full freedom for market participants to choose how (e.g. directly), where and if they centrally clear their trades; and
- Account segregation for client money held by clearing members, to enable to a smooth transfer of positions in case a clearing member goes bankrupt

CDWG members would be interested in further discussing these ideas with the European Commission.

## **6. INCREASE TRANSPARENCY OF PRICES, TRANSACTIONS AND POSITIONS**

### **(21) Should MiFID-type pre- and post-trade transparency rules be extended to non-equities products? Are there other means to ensure transparency?**

The extent to which comprehensive mandatory pre- and post-trade transparency requirements should be applied to commodity derivatives markets depends, to a large extent, on the perceived market failure that such requirements are seeking to address.

The vast majority of OTC transactions in commodity derivatives are priced with reference to readily observable market prices (either a benchmark futures contract or physical underlying) and so do not suffer from the pricing and valuation issues which have been associated with problems in some financial markets.

Ill-conceived pre- and post-trade transparency requirements for commodity derivatives risk negatively impacting liquidity and exacerbating volatility in the market. CESR and ERGEG, in their advice to the European Commission “came to the conclusion that there is no need to take action in relation to purely bilateral trading which often is so bespoke that transparency information would not add materially to the price discovery process”.

The CDWG agrees with CESR-ERGEG that there may be a case for greater post-trade transparency data in relation to standardized electricity and gas contracts undertaken on exchanges, MTFs and other electronic platforms (e.g. broker screens). Such requirements, however, must preserve the commercially sensitive nature of such information.

The CDWG also points out that much commercial information in relation to commodity derivatives transactions is already publicly available from commercial service providers. In a market where market participants are hedging against specific risks, pre-trade transparency would do little good and significant harm (exposing commercially sensitive risk positions to other market participants). We highlight that retail participation in equity markets is the main justification for *pre-trade* transparency in equity markets,<sup>2</sup> but note that retail participation in commodity markets is low.

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<sup>2</sup> See ESME-Advice, pages 87 - 89; see:

[http://ec.europa.eu/internal\\_market/securities/docs/esme/commodity\\_derivatives\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/esme/commodity_derivatives_en.pdf)

Instead of mandatory regulatory regimes, existing commercial service providers and industry lead initiatives (such as EFETnet or FORMAET) could provide already comprehensive pre- and post-trade transparency information.

**(22) How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?**

Transaction reporting can assist regulators in the detection of potentially abusive and manipulative behaviour in some financial markets. However, the extent to which transaction reporting is an effective supervisory tool in the context of OTC commodity derivatives markets is highly questionable.<sup>3</sup>

Transactional data on highly bespoke OTC commodity derivatives contracts is unlikely to yield any meaningful information for regulators seeking to identify potentially abusive or manipulative behaviour. A transaction report of the purchase of a jet fuel swap by an airline from an oil trader at a price agreed between the parties will simply tell the regulator exactly that. It will not provide any insight into the rationale for the transaction or the underlying risks it may be seeking to mitigate. Without additional context, the information is almost meaningless from a market surveillance perspective.

The significant costs and administrative burden – for both firms and regulators - associated with the implementation of comprehensive transaction reporting for OTC transactions far outweigh the minimal regulatory benefit such reporting would deliver.

The CDWG believes a more effective mechanism is to establish comprehensive record-keeping obligations on market participants (e.g. as in the 3<sup>rd</sup> energy package) that can be readily accessed by regulators upon request. The CDWG has detailed its support for this proposal in the context of the CESR-ERGEG review of market integrity, transparency and transaction reporting in the electricity and gas markets.

We are not aware of any major regulatory drive toward mandatory use of data repositories in the commodity derivatives sector. Though the idea may seem superficially interesting (regulators being able to go to one location for all relevant data) we are concerned that many of the complications associated with transaction reporting could equally apply (from the point of view of commodity firms) regarding central trade repositories for commodity derivatives and that the costs of establishing and maintaining such a facility (from the point of view of commodity firms) would outweigh the benefits (we believe there would be limited added value in terms of systemic risk containment or market integrity).

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<sup>3</sup> See ESME-Advice, pages 116 et seq ;

[http://ec.europa.eu/internal\\_market/securities/docs/esme/commodity\\_derivatives\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/esme/commodity_derivatives_en.pdf)

As noted above, existing commercial service providers and industry lead initiatives (such as EFETnet or FORMAET), as well as regulated trading platforms, could provide comprehensive information.

**(23) How should position reporting of derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on the exposures to particular contracts?**

The Commission Staff Working Paper states that enhanced transparency of positions “may enhance the resilience of the financial system”. Since it is widely acknowledged that commodity firms do not pose the same level of systemic risk as other financial market participants, the CDWG would question whether such reporting would provide any discernible regulatory benefit. In particular, such reporting would provide a distorted view of the risk profile of a firm where such derivative transactions are entered into in order to mitigate risks arising from their underlying physical business.

Similarly, position limits (in particular in relation to standardized, exchange-traded derivative contracts) provide limited regulatory benefits and can inadvertently reduce liquidity, thus impairing the ability of market participants to conduct orderly commercial transactions

## **7. MOVE TRADING TO MORE PUBLIC TRADING VENUES**

**(24) How can further trade flow be channel led through transparent and efficient trading venues? What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?**

It is crucial that there is freedom of choice with regards to the trading channel chosen by market participants unless there is clear evidence that a particular route is causing significant systemic risks to the integrity of the market. The CDWG does not believe this is the case for commodities. Firms see the various trading routes (bilateral, regulated exchange, MTF, OTC brokered) as complementary. The choice of which one is used will depend on a number of factors including the nature of the transaction being looked at and product availability; costs of trading; ‘market conditions’ (e.g. level of liquidity) etc. Firms should be free to continue to exercise a choice in this respect in order to allow them to execute their business efficiently and effectively. In addition, it is beneficial to retain choice of trading route as competition between ‘market operators’ is crucial for ensuring costs are minimized and product and market development is incentivised.

Where there is a need or desire for more ‘centralised’ trading then the commodity market has shown that there are no particular barriers to such solutions being developed. For example, a significant portion of OTC commodity derivatives volume – in particular in the more ‘vanilla’, liquid parts of energy markets – is already transacted or cleared at transparent, automated trading platforms such as exchanges, brokers, MTFs etc. Market participants use these platforms because it makes sense to use them in that segment of the market.

The European Commission is aware that there is already a highly developed exchange-traded commodity derivative market, transacting fungible, standardized commodity derivatives contracts, often of a smaller size than contracts typically transacted in the OTC sphere.

Making all contracts ‘uniform’ in the commodity derivatives sector will (a) not actually reduce overall systemic risk – as users will find it harder to enter into contracts that meet their specific risk mitigation needs and (b) not necessarily lead to markets moving to exchanges or electronic trading platforms.

Other factors that need to be considered include size of trades (many of the contracts traded OTC would be too large in volume to be transacted efficiently on exchanges e.g.) and related issues including nature of participants, frequency of transactions, liquidity and efficiency of price formation.

There are good reasons, in general, for requiring high levels of transparency in exchange-traded markets, not least of which include the significant level of retail participation, directly or indirectly in these markets. There is no significant level of retail participation in OTC commodity derivative contracts, whether transacted purely bilaterally or at brokers or on MTFs, and there is little logic in applying pre-trade transparency requirements at this level (in fact, such a step would cause considerable damage to these markets and discourage market participants’ investment in their businesses (as it could undermine their ability to hedge, risk concerns being divulged to the market).

The CDWG supports publication of post-trade data on vanilla contracts transacted at exchanges, brokers or MTFs or cleared at clearing houses (as many OTC/exchange-lookalike contracts are), by those infrastructures.