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ISDA's response to the ERGEG consultation on the regulatory oversight of energy exchanges

Introduction

On behalf of its members, the International Swaps and Derivatives Association (ISDA) takes the opportunity to comment on the European Regulators Group for Electricity and Gas (ERGEG) draft advice on the regulatory oversight of energy exchanges.

In principle, ISDA supports steps towards more convergence, without duplication, between regulation of physical commodity markets and financial markets and regulatory initiatives designed to improve the safety, soundness and functioning of these markets.

From this perspective, ISDA welcomes ERGEG's initiative aimed at enhancing and harmonizing energy market regulatory oversight, particularly ERGEG's recognition of the importance of ensuring that any duplication between financial regulation (*i.e.* MiFID) and the proposed energy regulatory framework is avoided.

ISDA supports the proposed Regulation on Energy Market Integrity and Transparency (REMIT) as it should result in a more level playing field between commodity market participants, will prohibit market abuse and thus enhance market integrity.

ISDA believes the issues raised in this consultation will accordingly help inform that debate, particularly in relation to further rule-making under REMIT.

ISDA welcomes the creation of a specific regulatory framework for the regulatory oversight of energy exchanges and believes the model set out within the MiFID framework offers a good starting point for discussion.

ISDA would like to highlight the points it considers essential for implementing an efficient and effective supervisory framework for energy exchanges:

1. A clearly defined objective and regulatory oversight structure

The main goal of an EU regulatory regime for energy markets should be the creation of EU-wide principles for energy exchanges which, while being appropriately tailored to these wholesale markets, promote consistency and harmonisation with financial markets regulation. Underlying this should be objectives which focus on improving market integrity, transparency, efficiency and market participant choice. Moreover, ISDA believes such an EU-wide regime should provide national energy regulators the scope to set core standards and for the individual exchanges to issue detailed (and appropriately tailored) rules in accordance with those core standards and overarching principles.

2. Licensing rules and organisational requirements

The effectiveness of regulatory oversight depends upon the organisational requirements that are outlined within the legislation; ISDA believes it is essential to design a licensing regime with consistent and appropriately robust organisational requirements, particularly to address systemic concerns, and which clarifies the relationship between ACER, national energy regulators and the exchanges.

3. Avoiding overlap with MiFID and loopholes in the supervisory framework

ERGEG should provide a clear definition of the exchanges that are subject to its proposed regime ensuring that those already covered by MiFID are excluded.

Furthermore, ERGEG/ ACER and ESMA need to agree how oversight of regulated markets, MTFs and physical exchanges that list both physical and derivative products would work to avoid overlaps of regimes and duplication of oversight. ISDA therefore urges ERGEG to take into account the definition of the markets in MiFID review.

4. More comprehensive transparency to the market

Current UK transparency arrangements, where the national grid publishes real-time information, is a model that should be adopted across the EU. The establishment of more transparency at the grid level is an important first step, but ISDA believes ultimately the authorities should be aiming to establish a real-time single central information platform. Exchanges should continue to publish traded volume and price data broadly as they do today.

5. Effective market surveillance to detect abusive market practices

Energy exchanges should install and maintain a market surveillance department. However, market monitoring needs to also take into account information at the grid level, as only when both of these information elements are combined will it provide a complete picture of the circumstances prevailing and therefore enable an accurate assessment to be made as to whether market abuse, in any form, has taken place.

6. Coordination between national energy regulators and role of ACER

Coordination between national energy regulators in their supervisory capacity and ACER, particularly in its monitoring role for market abuse under the REMIT framework is essential.

7. Convergent enforcement regimes and penalties

It is important to ensure there is coordination between member states in investigating abusive practices and convergence in enforcement regimes and penalties across Europe with regards to offences committed by market participants.

Responses to ERGEG consultation questions

Regulation of energy exchanges and the role of energy regulators

Question 1

In your view, is there a need to create EU level requirements for the organisation, functioning and regulatory oversight of energy exchanges not falling within the scope of MiFID? If yes, what should be the main goals and objectives to be fulfilled?

As a general matter, ISDA believes there should be further harmonisation in the regulatory frameworks applying to financial and physical commodities markets.

We recognise the important role that initiatives in the financial markets, such as MiFID and MAD have played in improving investor protection and choice, while enhancing market integrity and efficiency. While more remains to be done in terms of updating some parts of the existing framework for financial markets, we also acknowledge that greater focus is needed on making the regulatory framework for physical commodities markets more comprehensive. In this regard, we would highlight our support for the proposed regulation to tackle market abuse in the EU power and gas markets (REMIT) and the creation of an authorisation/passporting regime for power and gas traders in the EU¹.

¹ ISDA already expressed in June 2011 its support to the introduction of a energy wholesale trading passport in its response to the CEER's consultation paper.

We would stress the importance, as recognised by ERGEG in the consultation paper, of ensuring that the development of new regulatory regimes for the physical commodities markets takes full account of existing (and proposed) financial market regulation. We see close coordination and cooperation between ERGEG/ACER and ESMA as being vital to the development of commodities regulation which is fit for purpose. We would also underline the importance of ensuring that there is sufficient clarity in relation to regime scope, particularly where the physical and financial frameworks overlap and that new regimes function effectively, efficiently and does not present any opportunities for regulatory arbitrage between markets.

In light of our comments above, and given the increasing cross-border nature of the EU energy markets, we think it is appropriate for consideration to be now given to the creation of EU-wide regulation energy exchanges not falling within the scope of MiFID as long as there is a clear cost/benefit analysis conducted for the relevant regime and it avoids duplication/ overlap of regulatory effort.

We believe that the main goal of such a regulatory regime should be the creation of EU-wide principles for energy exchanges which, while being appropriately tailored to these wholesale markets², promote consistency and harmonisation with financial markets regulation. Underlying this should be objectives which focus on improving market integrity, transparency, efficiency and market participant choice.

Moreover, we believe such an EU-wide regime should provide national energy regulators the scope to set core standards and for the individual exchanges to issue detailed (and appropriately tailored) rules in accordance with those core standards and overarching principles. Vital to the success of such a structure would be the provision of appropriate expertise and resources at the national energy regulators, as well as ACER, and effective coordination between the national energy regulators and ACER to ensure consistency of approach.

Question 2

In your view, what are the remits of national energy regulators in supervising energy exchanges and how could a beneficial cooperation between them be organised, in particular for exchanges active under multiple national jurisdictions?

As the consultation paper notes, the roles and responsibilities of national energy regulators for the supervision of energy exchanges currently vary across the EU. ISDA believes an EU-wide regime for the regulation of energy markets should give regulators scope to set core standards (as opposed to detailed rules) in the following areas:

- Adequacy of financial resources;
- Competence and integrity of senior management;
- Effective governance arrangements; and

² and, in particular, take account of the type of market and the risks presented by that market (e.g. a spot vs a futures market where the risks within the futures market are far more elevated).

- Appropriate and sufficient systems and controls arrangements covering market access, risk management, conflict identification and management, protection of confidential information, IT infrastructure, business resilience, admission of contracts to trading, auction rules, market-making and trading, settlement, clearing, transaction recording, transparency to the market, monitoring market integrity, discipline and complaints.

We would highlight that credit and risk management standards of physical commodity exchanges and particularly clearing venues are a source of potentially significant systemic risk and should accordingly be subject to the same standards promoted by IOSCO for central counterparties for financial derivatives. Some existing physical commodity clearing houses (both in Europe and the US) are a source of systemic weakness, often creating unlimited liability and/or permitting thinly capitalised memberships and it is critical that these risks are addressed, particularly given the increasing levels of activity being conducted through physical commodity exchanges.

We see an important role for national energy regulators to play in coordinating, cooperating and sharing information with one another, which should help improve market integrity, transparency, and ultimately, efficiency and market participant choice. We would suggest consideration be given to the establishment of supervisory colleges, as well as giving ERGEG/ACER a central role in promoting cooperation and consistency in supervisory approaches and practices.

Question 3

Should the regulation of energy spot exchanges in future be covered by the energy market integrity regulation or by a separate future legal proposal by the European Commission?

As mentioned in our response to Question 1 above, ISDA supports the introduction of REMIT and believe it appropriate that both EU exchange and OTC energy trading be covered by this regulation, particularly so that it promotes a single clear EU-wide standard in relation to market abuse. As an aside, we note that REMIT is largely consistent with the market abuse regime currently operating in financial markets, which we believe has worked well.

We further note that the final text of REMIT, as well as covering market abuse, includes a national registration system for energy traders. On the basis that REMIT is going to be broader in coverage than just market abuse, we have no objection to it also being expanded to cover regulation of EU energy exchanges.

The definition of exchange rules (spot market)

Question 4

How could in your view a harmonisation of legal and operational frameworks stimulate the cooperation of the European energy exchanges and what is the best way to involve the market/exchange participants?

ISDA believes that the tiered approach outlined above, whereby an EU-wide regime would set the principles for regulatory oversight of energy exchanges, national regulators would set core standards and exchanges would set detailed rules in accordance with those core

standards and overarching principles, would be a pragmatic and practical approach to achieving harmonised oversight. We do not believe that EU-wide rules for energy exchanges should be excessively prescriptive, as that would risk constraining exchanges from issuing rules which were appropriately tailored to the market segment concerned and limit the scope for industry innovation.

As we refer to in our response to Question 2 above, we see a significant role for an EU-wide regime to play in establishing adequate systems and controls at energy exchanges, including a number of key operational issues. However, as a practical matter, we are unsure to what degree it would be feasible to harmonise legal frameworks, given the differing legal structures in place today across Member States.

On the question of the involvement of market/exchange participants, we are of the view that engagement with stakeholders is essential. As currently exists with some exchanges, we believe that processes should be established that require formal consultation with exchange members when material changes are being contemplated to the exchange's rules. The consultation process should be structured in such a way that concerns raised by exchange members are given appropriate consideration and sufficient time is permitted for exchange members to change their own operations, where required. We also believe it helpful for exchanges to establish standing committees, which include exchange members, in order to keep members sufficiently informed on key issues, as well as being a forum for providing feedback to the exchange from its own membership.

With respect to regulatory approval, we would suggest that rule changes being contemplated by an energy exchange which are expected to impact the standards required in the core areas we reference above in our response to Question 2, should be approved by regulators. However, we would not suggest national or EU level regulatory approval should be required for all proposed rule changes, as this would be overly burdensome and unlikely to yield significant overall benefit.

Market Makers

Question 5

Which criteria should a European framework for market makers include to avoid potential conflicts of interests?

As discussed above, ISDA believes that national regulators should be given scope to set core standards (as opposed to detailed rules) in a number of areas, including market-making. ISDA also highlights that not all energy markets have market makers and that where they exist they usually have been introduced by national law due to competition concerns or in order to facilitate liberalisation. The detailed rule-making should therefore be the responsibility of the energy exchanges and subject to overall approval by the relevant national energy regulator, in line with the principles contained in the EU-wide regime.

Specifically, in relation to identification and management of conflicts of interest, it is worth highlighting that the regime contemplated under REMIT will define inside information and set out the circumstances where the use of such information by *any* market participant,

including a market-maker, would be a breach of the rules and thus prohibited. We therefore see the introduction of REMIT as pivotal in addressing the concerns raised in ERGEG's consultation paper of the possibility of a conflict of interest arising "if a market-maker (or its ancillary company) is also a producer". Accordingly, we would expect information barriers (or "Chinese walls") to be established within integrated businesses to ensure information was appropriately contained.

We would anticipate that the energy exchanges would, within their own detailed rulebooks, set out clear guidance on a market-maker's obligations, including information handling responsibilities. We would furthermore underline the importance of effective monitoring and surveillance by the exchanges (as well as at the grid level), including coordination and information sharing with other EU exchanges/authorities given the cross-border nature of trading, as key to maintaining good standards of market cleanliness and overall market integrity.

Finally, we would add that we believe the definition of a market maker in MiFID is a pragmatic and practical one³ and would represent a good starting point for considering a definition of market-making for the EU energy markets.

Transparency

Question 6

How could national energy regulators better work towards publishing of price sensitive information as e.g. foreseen in the ERGEG advice on Guidelines on Fundamental Electricity Data Transparency to increase the level of transparency?

We believe that REMIT will play a critical role in addressing the current asymmetry of information in the EU energy markets through the imposition of new disclosure obligations relating to inside information, including on market participants who own/control energy businesses. We also welcome the wide definition of inside information proposed by REMIT. Further more detailed rule making will be required before REMIT can be implemented and we believe it essential that ACER consults with the national energy regulators throughout that rule making process, as well as coordinating with ESMA.

In terms of how the information should be disseminated, we are supportive of the current transparent UK model, where the national grid publishes real-time information and would like to see a similarly open and transparent approach adopted across the EU. We see the establishment of more transparency at the grid level as a first step and believe that ultimately the authorities should be aiming to establish a real-time single central information platform as referred to in the ERGEG advice on Guidelines on Fundamental Electricity Data Transparency. We believe that exchanges should continue to publish traded volume and price data broadly as they do today.

³ Market-maker means a person who holds himself out on the financial markets on a continuous basis as being willing to deal on own account by buying and selling financial instruments against his proprietary capital at prices defined by him.

Monitoring of energy trading

Question 7

Which measures could in your view lead to a sufficient cooperation of market surveillance departments of the energy exchanges and the national energy regulators?

ISDA believes there are two key components to energy market monitoring and surveillance which is effective at detecting abusive market practices. Firstly, we agree with ERGEG that “there should be an obligation for energy exchanges to install and maintain a market surveillance department”. However, we believe that market monitoring needs to also take into account information at the grid level, as only when both of these information elements are combined will it provide a complete picture of the circumstances prevailing and therefore enable an accurate assessment to be made as to whether market abuse, in any form, has taken place. In any event, any suspicions identified by the energy exchanges should be escalated to the national energy regulator for further investigation.

While we are therefore of the view that exchanges should undoubtedly operate properly resourced surveillance functions (both in terms of expertise and tools) to monitor their own market, we see it as more important that the national regulators are similarly resourced to review activity which takes combined account of the information/activity at the exchange and grid level.

Moreover, and where appropriate, the national regulator should be able to share that information with other Member State regulators to enable proper investigation of cross-border trading and, to similarly share their own national information when required. We therefore see as critical the development of an EU-wide mechanism which enables large volumes of detailed confidential transaction-level and other data to be shared between Member States in a form which facilitates effective analysis.

ISDA would highlight as helpful the inclusion in the final text of REMIT of the need for ACER to consult with the other authorities before establishing mechanisms for sharing transaction information and to pay “special attention” to safeguarding the information’s confidentiality. We also welcome recognition in the final text of REMIT of the need to avoid duplicating existing reporting requirements.

Finally, it will be important for the energy and financial regulators, both at a national level and ESMA/ACER level, to work together on market surveillance and investigations, given the interconnected nature of the financial and physical energy markets and the price impact one market can have on the other. It would also be helpful if both the exchanges and the regulators could share best practice in this area to help develop convergent best-in-class approaches.

The treatment of misbehaviours

Question 8

What are in your view minimum standards for a harmonised approach to protect energy exchanges from misbehaviours like market abuse?

While we acknowledge the findings set out in the ERGEG consultation that the treatment of market misbehaviour varies widely across Europe, we believe REMIT, when implemented, will for the first time create important minimum standards for market conduct and integrity across the EU energy markets, which will underpin the rule-making approach by the energy exchanges. As we said in response to earlier questions, we do not believe that EU-wide rules for energy exchanges should be excessively prescriptive as that would risk constraining exchanges from issuing rules which were appropriately tailored to the market segment concerned.

On a broader note, we would also highlight the European Commission's findings that enforcement powers and enforcement outcomes within the existing regulatory frameworks differ widely across the EU. We believe it important that the Commission and regulatory authorities take steps to ensure that the regime proposed under REMIT is consistently implemented across Member States and is also largely consistent with the provisions of MAD to avoid regulatory arbitrage opportunities arising. As was noted by the European Parliament in their deliberations on REMIT, ACER, ESMA, and Member States should coordinate their sanction system and agree minimum standards.

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