We are better informed, but are we any the wiser?

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Long before the banking crisis and the Libor scandal kicked off in 2008, regulators were hard at work trying to protect markets and investors from deliberate abuse and from structural flaws that could bring the whole system down in a cascade of cross defaults.

After 2008, the verdict on these efforts was 'must try harder' because the regulatory grip that had been tightening slowly since the European Investment Service Directive of 1993 had done nothing to stop abuse or to give an actionable warning of the banking bail out that was about to be needed.

Since then, the G20 leaders' summits have been attempting to restore global growth, strengthen the international financial system, and reform international financial institutions.

A significant step was taken in 2009 when the G20 leaders agreed that all standardized OTC derivative contracts should be cleared through a central counterparty (CCP) and that over-the-counter (OTC) derivative contracts should be reported to trade repositories (TRs) by the end of 2012. The objective was to increase transparency in the market, in the hope of being able to head off any future problems before they spiralled out of control.

This article focuses on Europe's contribution to the global agenda, which has taken the form of a series of Directives and Regulations.

Directives and Regulations

The first point to get clear is the difference between European Directives and European Regulations.

A '**Directive**' is a legislative act that sets a target that all EU countries must meet. However, under the subsidiarity principle, it is up to the individual countries to decide how they transpose the directive into national law. The directives that will be discussed in this article are:

'A DIRECTIVE IS A LEGISLATIVE ACT THAT SETS A TARGET THAT ALL EU COUNTRIES MUST MEET.'

- The Market Abuse Directive (MAD I) (2003/06/EC) had been implemented in 2005 by the European Securities and Markets Authority (ESMA), imposing administrative sanctions or compensation mechanisms under civil law on market abusers.
- The Criminal Sanctions for Market Abuse Directive (MAD II) (2014/57/EU) imposes additional criminal sanctions against abusers.
- The Market in Financial Instruments Directive (MiFID I) (2004/39/EC), which took effect in 2007, and its updated version, MiFID II (2014/65/EU) aims to increase transparency and limit exposure in the OTC market.

A '**Regulation**' is a binding legislative act. It must be applied in its entirety across all EU countries. If there is a national law that conflicts with the regulation, then that national law must be changed. The regulations that will be discussed in this article are:

- The Market Abuse Regulation labelled (596/2014) (MAR) will replace MAD I in mid-2016 within the scope of MiFID I. The scope will be widened to encompass MiFID II in January 2017. MiFID II and MAR have to be consistent in what they say and from when they apply, and therefore should be considered together.
- The Markets in Financial Instruments Regulation (MiFIR) updated and strengthened MAD I and led to the drafting of MAD II.
- Known as the European Market Infrastructure Regulation (EMIR), Regulation (EU) No 648/2012 on OTC derivatives, central counterparties, and trade repositories is intended to fulfil Europe's commitment to the G20 to increase transparency, to supervise the OTC derivatives market, and to level the playing field across all European member states (MSs).
- Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (Regulation on Energy Market Integrity and Transparency or REMIT) adapts the other market regulations to the cross-border characteristics of the gas and power markets.

'A REGULATION IS A BINDING LEGISLATIVE ACT. IT MUST BE APPLIED IN ITS ENTIRETY ACROSS ALL EU COUNTRIES.'

A Directive is unlikely to result in a speedy response to a crisis because it requires separate consideration and tailored drafting by each of the 28 European MSs individually. A Regulation can execute a call to action *comparatively* more speedily because it defines the consistent action to be taken across all MSs by a specified date.

Market abuse

MAD II/ MAR address market integrity and investor protection.

Market abuse, in European parlance, consists first of insider dealing (when a person trades in financial instruments while having inside information in relation to those instruments, not known to other market participants and likely to move the price). Secondly, market manipulation is also abusive, for instance, the spreading of false information, or entering into off-setting non-arm's length trades at off-market prices while only informing price-reporting agencies of one of the deals, while conducting trades in related instruments.

MAD I gave the regulator the right to investigate suspicious price moves, but it did not give sufficient legal certainty for the taking of administrative measures or for the imposition of 'effective, proportionate and dissuasive' sanctions in all European countries, although the UK Financial Conduct Authority (FCA) has taken a large number of successful actions against offenders.

Significantly for energy commodities, the MAR enters the difficult territory of regulating the physical commodity market. According to the FCA '*Commodity markets are unique in how their market activities straddle the regulatory boundary so that behaviour in the physical market can affect the financial markets and vice versa. This physical market activity is an increasingly key influence on the real economy.*'

This introduces the prospect of a regulator taking responsibility for regulation of the troubled oil market; for example, the Dated Brent price assessment, the 30-Day BFOE (Brent, Forties, Oseberg, Ekofisk) market, the Dubai crude oil market, and Singapore gasoline. Any regulator that takes on responsibility for the regulation of the physical oil market cannot draw a line at Europe, because oil is an intricately intertwined and very international market.

Not only do MADII/MAR extend regulatory oversight to new trading venues and financial instruments, including OTC commodity derivatives, they also give regulators more investigative powers (such as access to premises or phone records), and sanctioning powers (for example, EUR 5 million for an individual and EUR 15 million or 15 per cent of annual turnover for a firm).

In addition to clarifying and strengthening these administrative sanctions, custodial sentences of up to four years may be imposed on individuals found guilty of insider dealing or market manipulation, and up to two years for disclosing inside information unlawfully. It is intended that MAR will give whistle blowers more protection under law.

The UK has opted out of MAD II and is instead introducing its own separate criminal sanctions.

MiFID/MiFIR

MiFID/MiFIR address market efficiency, market safety, and transparency. The main objective of MiFID I was to create a common internal European market and to promote competition amongst trading platforms.

MiFID I took effect in 2007 – arguably playing a role in triggering the financial crisis by encouraging trade in OTC markets. This is because MiFID I did not adopt early proposals to oblige OTC trades to migrate to regulated markets (RMs). Instead, MiFID I recognized the concept of multilateral trading facilities (MTFs) that are not exchanges, but which were allowed to operate alongside RMs in an OTC market.

Operators of MTFs are able to offer more exotic and tailored products than those that are offered on RMs; however, MTF transactions are subject to less onerous reporting provisions so positions and exposures are consequently more difficult to track.

MiFID II / MiFIR recognizes a new actor – the Organized Trading Facility (OTF). Buyers and sellers of bonds, structured finance products, emission allowances, and derivatives can interact on an OTF in a way that results in contracts, for example broker crossing systems or inter-dealer broker systems. Running an OTF is an investment service and the operator must be licensed as an Investment Firm in the same way as an RM or MTF.

Unlike operators of RMs and MTFs, OTF operators have discretion in placing bids and offers and in matching orders, in accordance with clients' instructions. For example, a client of an OTF may specify that it does not want its orders matched with a particular counterparty with whom, for example, it may already have reached an internal dealing limit.

RM, MTF, and OTF operators cannot trade using their own proprietary capital, except in the case of illiquid sovereign debt instruments in the case of OTFs.

Otherwise OTFs are now held to broadly the same standards as RMs and MTFs in terms of transparent and fair, non-discriminatory, and orderly trading.

'MiFID II AND MiFIR ARE TIGHTENING UP MARKET SURVEILLANCE ACROSS ALL PLATFORMS TO IDENTIFY MARKET ABUSE.'

OTFs should not be confused with Systematic Internalizers (SIs). For example, the head office trading function of a major oil company or utility may act as a central dealer for its asset teams or its overseas affiliates. In doing so the SI may deal on its own account or match external orders more efficiently within its own greater

corporate book. SIs do not have to be licensed to carry out this activity.

MiFID II and MiFIR are tightening up market surveillance across all platforms to identify market abuse. Trading venues of all kinds are being held to high technical standards to ensure that they do not collapse when subjected to high volumes or volatile prices.

But where the new rules are being felt first, and by most firms, is in the area of transaction reporting and clearing. This requires more detailed regulations, such as EMIR and REMIT, and needs lengthy and detailed regulatory technical standards (RTSs).

EMIR

EMIR applies to futures, forwards, swaps, and options bipartite trades in the OTC market, including commodities. If a company is incorporated outside Europe (a 'third country entity') EMIR can still apply if the foreign company is dealing with a European company. The latter will have to oblige the non-European counterparty to comply with EMIR before they can trade. Similarly, if the deal involves a European instrument, or if the activity concerned can have an impact on a European market, it is within the scope of EMIR.

EMIR requires three things of derivative users, including users of commodity derivatives:

- Reporting of risk;
- Clearing of risk; and,
- Mitigation of risk.

Each deal is reported to a trade repository (TR), which aggregates it and passes it on to a national competent authority (NCA), through ESMA which analyses it for signs of international systemic risk.

The extent to which EMIR applies depends on whether the company concerned is a Financial Counterparty (FC), a non-Financial counterparty above a dealing threshold (NFC+), or a non-Financial counterparty below a dealing threshold (NFC–). Whether the company is NFC+ or NFC– depends on the size of its notional position over a rolling 30-day average period. The threshold in the case of commodities is greater or less than the figure of EUR 3 billion.

FCs and NFC+ companies have to do more than simply report deals. They have to give up the trade to a Central Counterparty (CCP) for clearing.

The risk mitigation requirements of EMIR require parties to deal responsibly by:

- Confirming trades promptly;
- Marking trades to market on a daily basis;
- Having a dispute resolution procedure in place;
- Performing portfolio reconciliation at regular intervals;
- Performing portfolio compression, i.e. netting off long and short positions held with the same counterparty;
- Exchanging collateral to secure trades which cannot be cleared; and,
- Applying higher capital adequacy obligations on FCs.

The good news is that transactions carried out for hedging purposes are exempt from the EMIR clearing threshold calculation, but the bad news is that if one of a consolidated group of entities exceeds the threshold then they all have to clear eligible trades, whether used for hedging or not. Moreover, as any trader who has ever dealt with auditors will confirm, proving when a trade is a hedge rather than a speculative punt is no easy matter.

REMIT

REMIT is similarly designed to increase transparency and root out market abuse, but it is specifically aimed at the wholesale energy markets (WEMs), including their derivative markets.

The interconnectivity of gas pipes and electric wires across Europe makes it difficult to assign the responsibility to police and deal with market abuse to a particular national regulatory authority (NRA). So an Agency for the Cooperation of Energy Regulators (ACER), a new governing body, has been created to implement and monitor REMIT reporting across Europe and to assess which NRA needs to be involved in any particular incident. It is the NRAs that are responsible for setting and enforcing national penalties for market abuse.

The target entity under REMIT is the 'market participant', which includes 'any person, including transmission system operators, who enters into transactions, including the placing of orders to trade, in one or more wholesale energy markets.'

End-users of wholesale energy may have a get-out clause if they only enter into contracts for the supply and distribution of electricity or natural gas for their own use and have a consumption capacity of less than 600 GWh per year.

However one important qualification is made for contracts traded at organized marketplaces: these all have to be reported to ACER.

The bottom line

The cost of compliance with these new Directives and Regulations will be enormous and it is already causing headaches for the banks,

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large multinational energy companies, and trading houses operating in the energy markets. Targeted entities are particularly frustrated by the need to report the same information to different regulators in different formats.

Smaller companies who really only want to use the markets for hedging purposes are likely to be driven away by the reporting requirements alone. That may be no bad thing, judging by the number of such companies who end up in court complaining that they had only authorized hedging and did not appreciate that their traders had gone to the dark side and started making speculative punts.

Small-scale hedgers may be regarded as collateral damage in the war against market abuse and systemic risk, but anything that reduces liquidity increases costs by widening bid–offer spreads.

The heavier regulatory hand we are now seeing must therefore achieve its objectives to have any chance of justifying the cost.

ESMA currently has a perfect opportunity to demonstrate the value of the regulatory effort.

As large trading companies such as Glencore struggle publicly with the consequences of low commodity prices, it would be reassuring to have a regulator confirm or deny fears that we are looking over another precipice of systemic risk, this time involving the big private trading houses. It would go a long way to silencing the critics if ESMA were able to either confirm or scotch persistent rumours that have been circulating for months that we are about to see another Lehman Brothers in the commodities market. Don't hold your breath!

Financial regulation in the energy sector: jumping the gun

Marco Kerste and Bert Tieben

The inclusion of energy OTC derivative trading in EMIR (European Market Infrastructure Regulation) strongly builds on the assumption that the sector poses risk of contagion towards the real economy. This hypothesis of systemic risk was not well tested as part of the regulatory preparation. We find that empirical evidence does not support the hypothesis, questioning the necessity of financial regulation in the energy sector.

'THIS HYPOTHESIS OF SYSTEMIC RISK WAS NOT WELL TESTED AS PART OF THE REGULATORY PREPARATION.'

When assessing the net benefits of regulation, it would be easy to take the intended contribution as a given starting point in terms of positive impact. Alas, in our experience this constitutes a typical example of 'jumping the gun', as the intended contribution of regulation is not always rigorously tested upfront. Where we expect that other contributors in this issue will focus on the impact of EMIR on energy commodity trading *after* the implementation, we focus on the question of whether it was necessary to include energy OTC derivative trading as part of the scope of EMIR in the first place.

OTC trading and perception of systemic risk – role of regulation

Let us first look at the intentions of EMIR: it aims to curtail systemic risk from over-the-counter (OTC) trading by introducing a set of legally binding rules to improve the transparency of OTC trading and diminish counterparty risk. This latter task is achieved by making central clearing an obligation. This obligation also extends to non-financial counterparties (NFCs), depending on the type of OTC contracts and the notional value of the contracts.

With EMIR, the scope of financial regulation is thus expanded towards non-financial sectors, assuming systemic risk can be channelled from non-financial sectors to the financial sector through the use of derivatives. Although the credit crisis indeed points at serious risks in OTC derivatives trading, the actual extent to which non-financial companies contribute to systemic risk has hardly been the subject of research. Policy discussions on EMIR have generally focused on regulation design and the necessity of practical rules. This does not mean that it is illogical to assume that non-financial sectors contribute to systemic risk via the use of OTC derivatives.

In their 2011 paper 'Regulating Systemic Risk: Towards an Analytical Framework' (*Notre Dame Law Review*, 86:4, page 1351) Anabtawi and Schwarcz define systemic risk as 'the risk that a localized adverse shock, such as the collapse of a firm or market, will have repercussions that negatively impact the broader economy'. The function of banks as financial intermediaries – being a condition *sine qua non* for funding the consumption and investments of many economic participants – implies a close relationship with the real economy. In other words: a disruption of this function has a direct impact on activities in the real economy. This puts financial institutions at the centre of the