

The Committee of European Securities Regulators
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CESR and ERGEG advice to the European Commission in the context of the Third Energy Package

Draft Response to Question F.20 - Market Abuse Consultation Paper

The CFA Institute Centre for Financial Market Integrity (“CFA Institute Centre”) welcomes the opportunity to comment on “CESR and ERGEG advice to the European Commission in the context of the Third Energy Package - Draft Response to question F.20 - Market Abuse” (the “Consultation”).

We are very supportive of CCSR and ERGEG Joint Group’s initiative to develop a Market Abuse regime and to promote market integrity in the electricity and gas markets. This becomes essential as the evolution of the infrastructure for electricity and gas will give rise to increasing opportunities for market abuse. The CFA Institute Centre supports fair and open markets and advocates for investors’ protection. Accordingly, we place great importance to Market Abuse, having participated in consultations on this subject over the past six years. Though not experts in the markets for physical gas and electricity, we identify market abuse issues common to both the physical and financial markets, hence our response to this consultation.

Specific Market Abuse legislation will become crucial in the context of an effective implementation of the Third Energy Package. It is difficult to imagine the establishment of a *fair and open* EU energy market without the support of an effective Market Abuse framework. In particular, the separation of the operation of gas and electricity networks from the business of providing gas or generating power (“unbundling”) should encourage investment and allow new players in these markets. We therefore support the drafting of new instruments in order for these new players to successfully enter these markets, increase consumers’ choice, and determine a more efficient functioning of EU gas and electricity markets.

We recognize the success of some Regional Initiatives, which demonstrate the merits of a bottom up approach in the regulation of these areas. However, this alone will not be sufficient against the background of complex legal frameworks. EU intervention is essential to enable the creation of a single European energy market, and an EU wide legal framework is necessary to ensure market integrity. Within this framework, addressing Market Abuse is essential for the Third Energy Package to be effective.

As for the Consultation proposals, we agree with the CESR/ERGEG analysis on the scope of application of the current Market Abuse regime, and its ineffectiveness in addressing market integrity issues in the gas and electricity markets. We also support the implementation of a tailor-made regime for these markets. This would allow for a clearer definition of the scope of the new provisions, and for greater consultation with market participants, which is important given the specificities of these sectors.

For what concerns increased pre- and post trade transparency, we favour the creation of a harmonised list of data at the EU level. This is an essential prerequisite for the creation of a single EU energy market and for an equal access to information. This list should mandate the disclosure of data that are essential for the creation of a competitive market. We refer in particular to transparency on network capacity and capacity utilization - fundamental prerequisites for the efficient operation of a competitive market.

However, even though full disclosure of network access data and price sensitive information would help erode market concentration and enhance surveillance capabilities, it would not be sufficient to address the market failures identified by the DG COMP inquiry.

Finally, in the areas of disclosure obligations, insider trading and market manipulation, the Centre is broadly supportive of the suggested measures, but advises CESR and ERGEG to avoid a full and immediate application of MAD style regulation to these sectors. Such regulation should be avoided firstly because of the strong physical characteristics of these markets, and more importantly, because price distortions and abusive practices in this sector are mostly due to the underlying physical infrastructure. This would not be affected solely by the application of Market Abuse regulation as it is currently intended. Such an application could therefore fail in delivering the expected results while at the same time reducing liquidity in wholesale markets for electricity and gas, as we explain in the attached response.

Overall, we believe that the proposals set out herein will help to produce a more coherent application of a Market Abuse regime to energy markets.

We attach our response that addresses the questions of the Consultation. Please do not hesitate to contact us, should you wish to discuss any of the points raised.

Yours faithfully,



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Our detailed comments follow the order of the Consultation's questions and are presented below.

Q1: Do you agree with the analysis of the market failures in the electricity and gas markets as described above? If not, please provide reasons for your disagreement.

Yes, we do agree. There is scope for market abuse practices in European electricity and gas markets, on the physical and on the trading level. Moreover, the regionalisation of these markets is creating increasing opportunities for abusive practices on cross-border transactions, as national regulators have in most cases purely national competences.

Q2: What is your opinion on the analysis provided above on the scope of MAD in relation to the three different areas: disclosure obligations, insider trading, and market manipulation?

We agree with your analysis on the ineffectiveness of the current Market Abuse regime in relation to the disclosure of information and the prevention, detection, investigation and sanctioning of insider dealing and market manipulation in electricity and gas markets. The lack of effective regulation has negative consequences for market transparency. This may lead to informational asymmetries (as recognised in the DG COMP Energy Inquiry). This could also allow incumbents to make use of their market power to effectively influence prices on both spot and forward markets.

Q3: Do you agree with the conclusion above that greater pre- and post trade transparency would not be sufficient in the context of market abuse?

Yes, we agree. Greater transparency could encourage new entrants into these markets and enhance regulatory surveillance. However, it would not help solve the extensive number of problems identified by the sector inquiry, and in particular market abuse. This

¹ The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

² CFA Institute is best known for developing and administering the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

is reinforced by examples of price-fixing behaviour detected by national regulators in EU domestic markets that took place subsequent to liberalizing efforts at the EU level.

Electricity

For what concerns electricity, increased transparency alone would not be enough. In this market, concentration in generation leads to distortions in pricing mechanisms. Additionally, in both spot and forward markets, excess generation plays a critical role in determining overall supply, and hence may be used to influence clearing prices - in particular at times of peak demand.

Introducing competition in these markets requires preventing Transmission System Operators (TSOs)³ from exercising a dominant position in transmission. This cannot be achieved through disclosure mechanisms alone. An essential component of a competitive market is establishing rules and terms for market access. This translates in the case of electricity into more efficient use of actual transport capacity, standardization of balancing mechanisms and procedures, and interoperability of national grids. These factors would certainly benefit from increased transparency and would more effectively tackle market abuse.

On the infrastructure level, the lack of disclosure regarding network constraints should be an issue of primary concern for EU regulators. In fact, this, combined with existing obligations on applicants⁴, gives too much leverage to vertically integrated companies not only to raise costs, but also to make the entry of new players in some cases *de facto* impossible.

Gas

Pre- and post trade transparency would not be sufficient in the market for gas. This is mainly a consequence of the limited role of trading in this market and of its limited impact on price formation, even in countries where the market share of traded gas is more relevant.

Increased transparency alone could not solve the problems arising from incomplete unbundling and difficult network access, and from the presence of long-term contracts. This often creates a natural monopoly for incumbents, determining an uneven playing field that may be conducive to abusive practices.

However, despite these elements and the need for action that follows, we are concerned that the urge to regulate this sector may lead to over-regulation that could eventually harm consumers. The presence of long-term contracts is an essential incentive for the development of new supply sources, but has negative consequences on the upstream wholesale market. Long-term contracts can actually prevent other users from successfully entering this market, thus discouraging wholesale competition. One solution is the creation of tradable property rights for transmission facilities (as in the United States) and

³ Because of incomplete unbundling of transmission networks from generation/supply operations, in several EU countries transmission system operators are still linked to generators, as it used to be within the incumbent vertically integrated utility of the pre-liberalization period.

⁴ Undertakings applying for an authorisation to build and/or operate facilities or applying for an authorisation to supply.

the further development of capacity rights⁵ trading (as experimented in the context of some Regional Initiatives). This would prevent incumbents from under-exploiting the existing network in order to benefit from price increases, and at the same time allow third party access whenever practicable.

Q4: Do you agree with the analysis above on the importance of transparency/disclosure of fundamental data? If yes, would you consider it useful to set up at the European level a harmonised list of fundamental data required to be published? Is an exhaustive list conceivable or is it necessary to publish additional data on an ad hoc basis if it is considered to be price sensitive?

Yes, we agree with CESR ERGEG analysis of the importance of transparency / disclosure of fundamental data. As evidenced by the DG COMP Energy Sector Inquiry (para. 257), a majority of network users identified the accessibility of data as a major issue and would favour the creation of electronic means of storage and access to such information. This becomes a crucial issue, as the ability to effectively compare different EU Member States would serve as a good indicator for new entrants to determine their risks in accessing new markets.

We also agree on the need to define and publish a harmonised set of data at the EU level. A prerequisite to enhance liquidity and transparency in these markets is a coherent regulatory framework, and a standardization of information at the EU level would certainly be a positive step in this direction. We also believe that the definition of the timing in which particular data must be disclosed should be explored. There is evidence that delays may be necessary under certain circumstances to protect operators facing unplanned outages and maintain liquidity.

Q5: Which information retained by specific participants of the electricity and gas markets (e.g. generators, TSO) should be published on an ad hoc basis if it is price sensitive?

The characteristics of gas and electricity make access to transmission networks extremely important in order to achieve market transparency. Therefore, data such as network capacity, capacity utilization, and scheduled closures or restrictions, are crucial in the erosion of informational asymmetries.

However, network information disclosure is not sufficient in the context of market abuse. Reaching an effective framework to detect and sanction abusive practices would entail the disclosure of all price sensitive information, such as generation, stocks, demand and supply forecasts, and costs for balancing the network.

Q6: What is your opinion on the proposals of CESR and ERGEG in the three different areas: disclosure obligations, insider trading and market manipulation?

⁵ As mandated by Gas Directive, Art. 6.

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:176:0057:0078:EN:PDF>

We support the decision to propose a new framework for gas and electricity markets rather than draft amendments to the current Market Abuse regime. As witnessed with the application of MAD to commodity derivatives, the inclusion within the same legislative instrument of multiple fields can come at the expense of the effectiveness and clarity of regulation. This is particularly relevant when different areas of application need tailor-made definitions.

As for the regulatory suggestions, the Centre generally agrees with what has been proposed, but with a few important caveats. The survey included in DG COMP Inquiry⁶ clearly indicates that greater transparency is needed. Nonetheless, regulators should be cautious not to overburden market participants and should carefully take into account the specifics of gas and electricity markets when deciding over the creation of a tailor-made Market Abuse regime for these sectors. Over-regulation could result in a decrease in market liquidity. Hence, technical dialogue with exchanges, Multilateral Trading Facilities (MTFs), national regulators and market operators must be an essential part of this process.

Disclosure obligations

Greater transparency is welcome in this area, as it would promote market integrity and enable the development of more efficient wholesale markets. As CESR and ERGEG acknowledge, the existing framework does not ensure full transparency and does not prevent information asymmetries from distorting competition. We therefore support increased transparency measures such as those included in recent Commission's proposals⁷.

However, doubts on the full implementation of a Market Abuse Directive style regulation arise when considering the peculiarities of gas and electricity markets. As pointed out by the ESME Report on Commodities Derivatives⁸, it is *problematic* to apply the Market Abuse Directive provisions to transactions in commodities. A good example of this is where participants with inherent physical positions are affected in their generation capacity by unplanned events. The definition of such events as inside information, and as a consequence their required full disclosure, is debatable. A generator incurring an unplanned outage needs to manage and hedge its position. However, full and immediate disclosure in this instance could be detrimental to the operator relative to other market participants, without any clear benefit for economic efficiency and market liquidity. An adaptation of Art. 6 Para. 2 of MAD regarding "delayed information under issuer responsibility" could be envisaged.

The example provided by Nord Pool Market Conduct Rules may be a useful starting point for a deeper discussion with interested parties. Technical discussions could cover the introduction of MW thresholds above which information must be disclosed, and the

⁶ See Directive amending Directive 2003/55/EC concerning common rules for the internal market in natural gas, at <http://ec.europa.eu/comm/competition/sectors/energy/inquiry/index.html>

⁷ COM(2007) 529 final. Provisions would allow regulators to have access to information on the operational decisions of companies, which would be obliged to keep record of the data related to their operational decision for five years. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0529:FIN:EN:PDF>

⁸ See "Mandate to ESME for 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", at http://ec.europa.eu/internal_market/securities/docs/esme/commodity_derivatives_en.pdf

definition of allowed delays (even longer than the “as soon as possible and no later than 60 minutes” rule in Nord Pool). These details should however be discussed in further streams of work at level 1, if a brand new market abuse regulation were to be implemented for these sectors.

Insider trading

We support the CESR/ERGEG proposal to establish a tailor-made insider trading framework. We understand how this would create new costs for markets, however the Centre believes that transaction reporting should be the primary responsibility of exchanges and not of market participants. Directing trading regulation to exchanges rather than to the firms operating in them would avoid overburdening market actors.

A good example of such a model may be found in the US Commodities Futures Trading Commission regulation on Commodities Pool Operators. This lists among the requirements the preparation and distribution of disclosure documents and account statements, the maintenance of records concerning the participants, and the transactions and operations of the pool. Moreover, counterparties of transactions on auction-based spot markets cannot identify specific wholesale suppliers/customers, but only the central counterparty operating in the market.

This approach would avoid the need for market participants to create an internal compliance organization (para. 102 of the Consultation), making the full implementation of the new Market Abuse regime in these sectors more gradual. This is especially true given the difficulties experienced with suspicious transaction reporting in financial markets⁹, and even more so since, as CESR and ERGEG admit, costs are difficult to estimate at this stage (para. 103 of the Consultation).

As for the extension of MAD to commodity derivatives traded on MTFs (para. 106), the Centre advises CESR and ERGEG to evaluate the effectiveness of MiFID in regulating these markets and the additional costs incurred by market actors. This could constitute an excessive regulatory response, as it would impose disproportionate compliance requirements on operators (independently from their size and resources). It could also be of little effectiveness given the rising number of commodity derivatives traded OTC. These considerations raise doubts on the feasibility and opportunity of such an extension, especially in view of the possible repercussions on other sets of products.

Market manipulation

As the Commission recognizes, existing unbundling provisions are not sufficient to ensure a well-functioning market. The manipulation of prices on physical markets is at the moment a structural consequence of the underlying generation and transmission infrastructure. Before implementing specific regulation on market manipulation in these markets, the current provisions in the Gas and Electricity Regulations should be strengthened. A specific Market Abuse policy response applied to the current situation could simply overburden market actors without addressing market concentration. In this case, the expected benefits would not arise.

⁹ See the Centre’s response to CESR Consultation “Market Abuse Directive, Level 3 - Third set of CESR guidance and information on the common operation of the Directive to the market”, at <http://www.cfainstitute.org/centre/topics/comment/2008/080814.html>

Overall, the fact that CESR and ERGEG would favour a tailor-made framework for products not covered by MAD in the sector legislation is a move in the right direction. Such an approach would diminish the risks associated with a full implementation of the same Market Abuse regime to physical markets. It would also allow for fine-tuning to account for the specificities of electricity and gas markets.

29th August 2008.