

- Position Paper –

## **KIDs requirement under PRIIPs Regulation incompatible with wholesale energy trading**

**Brussels, 9 March 2016** | Given the latest draft of the Regulatory Technical Standards (RTS) on the layout of the Key Information Documents (KIDs) introduced by the Regulation on Packaged Retail and Insurance-Based Investment Products (PRIIPs Regulation), it seems that the scope may have been unintentionally changed and is now affecting also energy markets. With this position paper, Europex would like to express its concerns regarding this new development. While we support the Commission's objective of improving the ability of retail investors to compare products and understand their features, we would like to highlight that the laid out requirements are incompatible with wholesale energy products. **As they are highly inadequate for energy market participants, we believe they risk hampering energy retail markets and the European energy market as a whole.**

In this paper, **we will explain why the final RTS should clarify that not all derivatives, and in particular not exchange traded commodity derivatives (ETCDs), qualify as “packaged retail investment products” (PRIIPs). We think such a clarification is necessary because the draft RTS may be misconstrued, as if it brought into the scope of the PRIIPs Regulation all derivatives, not only those that fit the definition of a PRIIP, as outlined in article 4 (1) of the PRIIPs Regulation.**

To start with, one should be aware of the fact that energy derivatives, CO2 emission allowances and other commodity derivatives are primarily used for hedging purposes by companies with an underlying physical business, and not by retail consumers for investment purposes. From this fact stem a number of crucial consequences:

Firstly, the purpose of the hedging strategy is to obtain exactly the opposite result of the derivative as a stand-alone investment. While derivatives as stand-alone instruments may be bought in order to gain from price fluctuations of the underlying instrument, energy/commodity market participants use ECTDs to hedge against price changes of the underlying commodity. Furthermore, there is a strong connection to their physical business: an energy future can be

used to hedge the risk of price decrease by an energy producer and to hedge the risk of price increase by a big energy consumer. Ignoring the underlying purpose of derivatives brought into the scope of the PRIIPs Regulation, will **result in KIDs that contain misleading information in case of these instruments.**

Secondly, we believe that classifying energy/commodity market participants as retail investors does not help either. Energy/commodity market participants have been trading professionally to hedge their commercial or investment risks for years, through which they have gained the necessary expertise. In some Member States, in order to conduct such a trading activity - even though it is ancillary to their main business-, market participants are required to hire professionals, which are licensed by either national competent authorities or respective exchanges. Hence, treating such entities as retail investors that have limited experience with financial instruments, regardless of whether they are natural persons or companies, seems inadequate and even unjust. **Energy/commodity market participants simply do not need such a simplified risk assessment, as provided by the KIDs.**

Thirdly and most importantly, we believe that **ETCDs do not share distinctive qualities of actual PRIPs as defined in article 4 (1) of the PRIIPs Regulation.** Interpreting the RTS in a way that allows for the overextension of the PRIIPs Regulation to ETCDs would go beyond the letter or spirit of this legislation. The definition of a PRIP in article 4 (1) of the PRIIPs Regulation uses a specific factor to distinguish it from other “investments”, i.e. the obligation for the issuer to repay the certain amount of invested capital. Said amount depends on “fluctuations because of exposure to reference values of one or more assets which are not directly purchased by the retail investor”. The vast majority of commodity derivatives, including all ETCDs, however, are not characterised by any repayment at maturity, which excludes them from the scope of the PRIIPs Regulation, given that the legislation does not explicitly include ETCDs by any of its provisions.

The definition, although wide, is clearly designed to bring non-insurance based packaged retail investment products into the scope of rules regarding disclosure of information to retail investors. **ETCDs are standardised contracts**, not packaged products. Article 4 (1) and Recital 6 of the PRIIPs Regulation refer to products designed to provide investment opportunities for retail investors, whereas ETCDs do not have any retail-specific or exclusive features of distribution. ETCDs are not publicly offered through a primary market issuance. They are designed to be traded on exchange, which implies an entirely different role and

interests compared to a product manufacturer. Operating a regulated market is a regulated activity under Title III of the Markets in Financial Instruments Directive 2004/39/EC (MiFID).

These rules require market operators to admit contracts to trading by approving standardised terms relating to the trading and settlement of contracts between exchange members. **A market operator is not a counterparty to an ETCD** or any other transaction between market participants **and has no management or economic interest in the performance of any contract**. A product manufacturer, on the other hand, designs product features to meet specific investment objectives. It has a contractual relationship with the investor and an economic interest in the performance of the contract.

Recital 12 of the PRIIPs Regulation provides an indicative list of entities that are PRIIPs manufacturers, entities “that are in the best position to know the product”. The list includes “fund managers, insurance undertakings, credit institutions or investment firms”. A market operator is a materially different type of entity from these insurance and investment firms.

We further note that the examples of investments provided in the legislation – “investment funds, life insurance policies with an investment element, structured products and structured deposits” – are all financial products designed to meet specific investment objectives. ETCDs are merely “building blocks” used in the construction of the packaged products specified in the PRIIPs legislation. **ETCDs do not involve the wrapping together of assets to create different exposures, different product features or cost structures**. ETCDs are merely financial instruments with no specific retail investor objective, purpose or performance scenarios.

**Fourthly, if ETCDs were to be included in the PRIIPs Regulation, most KID requirements would be inapplicable to them.** The design of the KIDs clearly indicates that the KID is customised towards the entities that offer investments as a special purpose vehicle, issuer or entity that securitises instruments. It cannot be appropriately completed by a neutral market operator, offering instruments that do not share the same qualities as actual PRIIPs. **The production of a KID per single ETCD would be operationally unworkable for any market operator**, because the KID format and content are inadequate for ETCDs. Those deficiencies are numerous. Below we list the most significant ones:

1. An ETCD serves a range of purposes and strategies that cannot be described in the given format of a KID.

2. ETCDs have no intended market/target group other than energy/commodity market participants.
3. The ESAs have assigned exchange traded derivatives (ETDs, which is a broader product group, including ETCDs) to the highest market risk category (MRM 7), based on a qualitative assignment that ignores the credit risk. Considering that most ETDs are centrally cleared by CCPs, which have the role of mitigating the counterparty risk to the maximum extent, we believe such categorisation to be misleading. Furthermore, it is unfeasible to calculate VaR for ETCDs (per individual series/product).
4. The performance scenarios required in the draft regulation are not compatible with the practice of ETCD contracts. If provided, they would provide meaningless information, because performance scenario differs per individual trade.
5. ETCDs allow buying and selling assets of which the prices are reliable and publicly available.

Please bear in mind that the afore-mentioned examples do not constitute an exhaustive list of all inadequacies of applying the PRIIPs Regulation's requirements to ETCDs. Moreover, similar arguments are valid for most energy/commodity derivatives, which are used for risk management purposes by professionals, who have vast experience in dealing in the energy/commodity markets. **Equating their level of protection with that of average individual investors, who are not as well equipped to make their trading decisions, would be superfluous and unreasonable.** It would also pose as serious as undue organisational and financial challenges, which would **increase transaction costs and limit hedging options, potentially undermining the internal energy market.**

In ANNEX I, we explain for each field separately the difficulties for commodity trading venues to complete the KID as currently proposed by the ESAs.

Against this background, **Europex calls for a clarification in the final RTS, to the effect that derivatives which qualify as PRIIPs are considered to be derivatives which involve the wrapping together of assets to create different exposures, different product features or cost structures and which include the obligation of the issuer to repay a certain amount of the investment.** Such an addition would make it clear that simple ETCDs, which are necessary for hedging of commercial risks of energy market participants, are not in the scope of the PRIIPs Regulation or the RTS to it. This would contribute to legal certainty for energy/commodity markets participants.

**ANNEX I Draft KID (as proposed) from an energy exchange and ETD perspective**

<b>KID FOR A SINGLE ENERGY FUTURE</b>		
<b>1.</b>	<b>Purpose</b>	<b>Could be provided – e.g. securing a certain price of energy at some point in the future (e.g. in a month).</b>
<b>2.</b>	<b>Product</b>	<b>Could be provided – e.g. a one month energy future.</b>
<b>3.</b>	<b>What is this product?</b>	
<b>3.A</b>	<b>Type</b>	<b>Could be provided – e.g. an energy future.</b>
<b>3.B</b>	<b>Purpose</b>	<p><b>Cannot be provided in a more meaningful way than in point 1. (securing a certain price of a commodity at some point in the future).</b></p> <p>An ETCD contract, such as a future, serves a range of purposes and strategies, all of which cannot be described in the given format of a KID. Furthermore, a commodity exchange is not aware of purposes and strategy of any investor buying or selling such an instrument – e.g. the same future can be used to hedge the risk of price decrease by an energy producer and to hedge the risk of price increase by a big energy consumer.</p>
<b>3.C</b>	<b>Intended market</b>	<p><b>Cannot be provided in a more meaningful way than: energy market participants (producers of electricity or natural gas, shippers of natural gas, wholesale customers, transmission system operators, storage system operators, LNG system operators, investment firms, energy trading companies, big end users, others).</b></p> <p>According to MiFID Article 16 and 24 (2) it appears the target group is meant here. For ETCD contracts no intended market/target group is specifically declared. Clearly, <b>an energy exchange does not sell instruments</b>, as much as it also does not buy instruments. No position is assumed as a market operator. MiFID II is very clear that regulated markets cannot engage in any sort of proprietary trading. Moreover, <b>the admission process describes who can be admitted as an exchange participant</b> – consumers (understood as natural persons) have no contractual agreement with an energy exchange and cannot be market participants. The products are not designed specifically for a target audience other than energy markets participants.</p>
<b>4.</b>	<b>What are the risks and what could I get in return?</b>	
<b>4.A</b>	<b>Risk indicator</b>	<p><b>Cannot be provided.</b></p> <p>The risk indicator as suggested by ESMA focuses on the individual product, purpose and further parameters resulting from the investment advice, such as the ‘recommended holding period’. ESMA suggests that derivatives that qualify as PRIPs are categorised under the highest risk category.</p>

		<p>We cannot comment on the entirety of the risk indicator for such derivatives that could qualify as PRIPs and are sold by the defined entities.</p> <p>What we do know as energy exchange, though, is that we do not have a full picture and therefore cannot provide an appropriate risk indicator, since investors use ETCDs for different purposes, mainly for hedging variety of commercial and investment risks, not to assume more risk in hope of a return.</p>
4.B	Performance scenarios	<p><b>Cannot be provided.</b></p> <p>The performance scenarios required in the draft regulation are not compatible with the practice of ETCD contracts, if provided, <b>will provide meaningless information.</b> A performance scenario differs <b>per individual trade.</b></p> <p>In case of a single energy future, the price of underlying will either increase or decrease, but the price in the future is set at a level that is acceptable to a market participant who traded this contract. If it was not, they would not trade this future, but other contracts that satisfy their business needs. The purpose of future is basically to hedge the risk of price fluctuations, securing the price that is acceptable e.g. in a month. Hence, a future is actually a risk management tool protecting investors from undesirable developments in the market for the underlying. Consequently, performance scenarios do not and cannot apply to an energy future.</p>
5	What happens if XYZ Asset Management is unable to pay out	<p><b>Cannot be provided.</b></p> <p><b>Exchanges do not pay out: exchanges are not issuing such products</b> and furthermore are not selling energy futures (or any other ETCDs) to investors. There is <b>no contractual agreement between retail investors and exchanges.</b></p> <p>Clearing houses guarantee the payout in ETCD transactions, in case of a default by the other contracting party.</p>
6	What are the costs	
6.1	Costs over time	<p><b>Cannot be provided except for the exchange fees. Fees collected by the intermediaries (exchange members) cannot be provided by the exchange due to fact they are different and could be negotiated by the client with the intermediary.</b></p> <p>The costs over time cannot be predicted by exchanges. Fees are made transparent to the market participants, but <b>any additional costs incurred by the investment firms marketing instruments or combination of instruments cannot be foreseen and therefore, described by an exchange.</b></p>
6.2	Composition of costs	<p><b>Cannot be provided.</b></p>

		<b>Market operators make their fees transparent, but are unable to comply with these requirements as they have no knowledge of or influence over costs in the chain of trading a listed derivative.</b>
7.	<b>How long should I hold it and can I take money out early?</b>	<b>Cannot be provided.</b> ETCD contracts are available for trading on every open trading day, so positions can be closed against the market price. <b>The investment or hedging objective of a single investor is unknown</b> and therefore, the question cannot be adequately responded.
8.	<b>How can I complain?</b>	<b>Cannot be provided.</b> Exchanges publish all rules and regulations, including those pertaining to complaints relevant to their activities or services, but they <b>cannot be held responsible in any way for unsatisfactory investment advice, because they do not provide investment advice.</b>
9.	<b>Other relevant information</b>	<b>Could be provided.</b> Market operators publish all rules and regulations, admission procedures, market models, derivatives contracts specifications, exchange fees, etc. on their website. <b>Cannot be provided.</b> <b>Any information relating to an investment advice.</b> A market operator is neutral by nature and as mandated by the relevant EU legislation (e.g. MiFID II). See points above.

## About:

Europex is a not-for-profit association of European energy exchanges with currently 26 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

## Contact:

Europex, Rue Montoyer 31, 1000 Brussels, Belgium

Telephone: +32 2 512 34 10

[www.europex.org](http://www.europex.org)

Email: [secretariat@europex.org](mailto:secretariat@europex.org)

Twitter: Europex\_energy