

# Overview of Potential Brexit Issues relating to Trading and Financial Regulation

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A EURELECTRIC paper

October 2017

***EURELECTRIC is the voice of the electricity industry in Europe.***

*We speak for more than 3,500 companies in power generation, distribution, and supply.*

***We Stand For:***

***Carbon-neutral electricity by 2050***

We have committed to making Europe's electricity cleaner. To deliver, we need to make use of **all low-carbon technologies**: more renewables, but also clean coal and gas, and nuclear. Efficient electric technologies in **transport and buildings**, combined with the development of smart grids and a major push in **energy efficiency** play a key role in reducing fossil fuel consumption and making our electricity more sustainable.

***Competitive electricity for our customers***

We support well-functioning, distortion-free **energy and carbon markets** as the best way to produce electricity and reduce emissions cost-efficiently. Integrated EU-wide electricity and gas markets are also crucial to offer our customers the **full benefits of liberalisation**: they ensure the best use of generation resources, improve **security of supply**, allow full EU-wide competition, and increase **customer choice**.

***Continent-wide electricity through a coherent European approach***

Europe's energy and climate challenges can only be solved by **European – or even global – policies**, not incoherent national measures. Such policies should complement, not contradict each other: coherent and integrated approaches reduce costs. This will encourage **effective investment** to ensure a sustainable and reliable electricity supply for Europe's businesses and consumers.

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## Impact from financial regulation on energy trading

Financial markets play a particularly central role for the hedging of risk within the energy sector. This is done mainly via commodity derivatives but also treasury risks such as currency risk and interest risk that are generally hedged by the energy industry. Transactions mitigating these risks often become financial instruments. If an energy transaction fulfils the criteria for being classified as a financial instrument several financial rules are triggered which are not always appropriately well designed for the 'energy world'.

For this reason, several exemptions are made to keep energy (commodity) transactions out of the regulatory space of financial regulation. However, such exemptions are often not well-suited in terms of a Brexit situation. Moreover, today, a significant part of the trading venues (mainly brokers) used for hedging energy risks are located in the UK.

## Framework around energy trading

Energy and emissions are traded on trading venues (exchanges) and over-the-counter (OTC) mainly based on standard master agreements (e.g. EFET, ISDA, IETA emissions trading master etc.). Several changes to the operation of these contracts could occur as a result of Brexit and will need to be catered for contractually and in the associated legal framework. Potential impacts include:

- ) **Governing law.** The ability to enforce judgements from English courts across the EU is currently enshrined as a principle in EU Regulation and many contracts specify UK governing law as a result. This could raise issues if enforceability of UK law is not recognised across the EU following Brexit.  
Furthermore, the UK will not be part of the processes securing alignment of rules and their interpretation, such as Q&A's made by EU institutions like ACER and ESMA. Thereby, even similar rules may make the legal positions different with a negative impact on the exchange of energy and related hedging of risks.
- ) **Close-out netting and collateralisation.** In the event that EU Insolvency Regulation (or similar replacement arrangements) no longer applies in the UK, there is a potential that close-out netting arrangements would also no longer apply which could mean a higher requirement for risk collateral.
- ) **Clearing.** While clearing could (and should) be able to take place freely in any jurisdiction for significant reserve currencies (£, \$, €), there would expectedly be a movement by the EU zone to repatriate Euro clearing to EU countries for financial security and stability reasons. This could affect Euro denominated contracts currently traded and cleared on UK venues.

- ) **Complexity.** Even smaller differences, being legally based or practically, may have a severe effect as the level of complexity in general makes such differences challenging and costly, (e.g. IT-wise) to handle. Once again, this would have a negative impact on the exchange of energy.

### **Regulation of Market Conduct: REMIT (gas and power) and MAR (gas, powers, EUAs and other asset classes being financial instruments)**

The substantive prohibitions in REMIT and MAR regarding market abuse, insider trading and the obligations for the publication of inside information would not necessarily continue to apply in the UK post-Brexit. Brexit could also end the “automatic” cooperation and sharing of data between national regulators and ACER in supervising cross-border trade.

However, the UK has to date taken a strong line on market transparency and abuse and it seems likely that the UK government would just replace (transfer) the substantive prohibitions of REMIT and MAR with legislation and cooperation arrangements to achieve similar aims. There remains a risk of different approaches to market oversight and supervision by Ofgem, FCA and neighbouring regulators, but that risk arguably already exists.

### **Transaction Reporting under REMIT, EMIR and MiFIR**

In terms of transaction reporting, the UK is likely to continue to want commodity derivatives and physical transactions to be routinely reported to UK regulators (FCA and Ofgem). The ideal would be for this to be achieved via arrangements linking into the existing EU infrastructure surrounding ACER, EMIR Trade Repositories and MiFID trading venues in order to avoid the duplication of existing systems. If that is not possible, it may be necessary to report UK transaction data separately. The risk here is that the protocols and standards used to report data diverge resulting in unnecessary and costly duplications of systems.

As the UK will become a third party country under EMIR, there would be a need for its national arrangements to be deemed equivalent by the European Commission. This process is time consuming and may restrict the extent to which a UK EMIR can diverge from the EU EMIR. However, there may be some flexibility within any UK EMIR around how restrictions on proprietary trading operate and on the requirement to report derivative transactions to the UK regulator.

### **Boundaries and Access to Commodities and EUAs Financial Markets: MiFID II/R**

The overall framework and broad requirements in MiFID are likely to be replicated in UK legislation. UK-based financial firms will need UK equivalent MiFID legislation to access EU markets and customers. The precise nature of the post-Brexit transition and enduring arrangements will determine whether existing “passporting” arrangements are maintained, whether the UK is treated as a third-country, and whether the UK is recognised as an “equivalent” jurisdiction. This will determine the extent to which a separate local presence or licence is required both the UK and EU respectively for both firms and regulated persons. Furthermore, this will influence whether a transaction is deemed a financial instrument and, thus, implying several pieces of financial regulation need to be observed besides MiFID.

Brexit is unlikely to restrict where contracts can be traded and it should continue to remain possible to trade contracts with a UK underlying on EU venues and vice versa (and indeed to trade contracts with a UK or EU underlying on third country venues, e.g. Singapore, Chicago etc.).

However, there are likely to be several legal and practical impacts on the operation of key MIFID provisions for companies based in the EU and trading in the UK, which could affect where companies choose to trade. These include for example:

- ) **Ancillary activity exemption.** The exemptions of financial instruments are tied to whether a transaction takes place in or outside of the EU. Thus, whether or not transactions traded on UK venues and/or for delivery in the UK contribute towards the tests. That is to say, to be performed in order to prove the trading activity in commodities and EUAs of an industrial group is ancillary to main activity of the Group, where the geographical scope of the market size is the EU.
- ) **Position limits.** How and whether transactions in UK contracts contribute toward position limits in the EU energy derivative markets and how UK and national European regulators choose to enforce those limits (e.g. unilaterally or cooperatively).

From January 2018, under new rules within MiFID II, broker platforms will likely be regulated as Organised Trading Facilities (OTFs). However, MiFID II includes a so-called 'REMIT carve-out' for physically settled power and gas agreements traded at these OTFs, meaning that **these trades are not financial instruments**. Though, if the UK is considered as a third country, continued UK-based trading of physical gas and power may not be counted under the REMIT carve-out, thus makes a big difference in terms of ability to be exempted from licensing besides the other requirements outlined above.

While we would expect negotiations to drive toward broad equivalence of financial regulation, there may be some scope for the UK authorities to adopt a more flexible approach on more detailed commodity issues post-Brexit. For example, the UK may choose to adopt a more relaxed licensing, position-limit and prudential regime for commodity firms (not least because the FCA is tasked with the vast majority of MiFID implementation given the current concentration of commodity firms and venues in London).

EURELECTRIC pursues in all its activities the application of the following sustainable development values:

Economic Development

▶ Growth, added-value, efficiency

Environmental Leadership

▶ Commitment, innovation, pro-activeness

Social Responsibility

▶ Transparency, ethics, accountability



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