Markets View - June 2024

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Welcome to the June edition of Markets View. It's been a busy month (and a busy week, in fact!) for market regulation issues – no doubt with more to come when the dust settles after the UK general election. So without further ado let's get stuck in to some of the biggest stories! As ever, we'd be delighted to hear any comments or questions you may wish to share.

EPEX Spot/EEX: Power Down

A glitch on the Paris-based EPEX Spot power market brought havoc to the European power markets on Wednesday. The root issue was an IT failure, which caused delays to the normal auction process in the **day-ahead gas market**, and which ultimately led the exchange to fall back on 'decoupled' auctions at the member state level (thereby disregarding important cross-border power flows).

The price impact was significant: German Power settled at **€492** for 26 June delivery, whereas French power settled at **€3** – a massive spread, at least an order of magnitude greater than the June average, and one not reflected in pricing on other power venues.

To make matters much worse, the fallout isn't by any means limited to trades on EPEX Spot itself. Financially-settled power futures traded on exchange behemoth (and EPEX Spot affiliate) EEX are priced against EPEX Spot's day-ahead auction settlement price.

For many readers, this will undoubtedly bring back memories of the 2022 LME nickel crisis. There are some important differences in the fact pattern, but we know that market participants (and regulators) will again be looking at this intently and will want to know what went wrong, what action (if any) either venue should have taken, and who is responsible for the mess. The latter two questions in particular involve delving into the venues' labyrinthine rules and procedures – something we at S&S are fortunately well-placed to do thanks to our award-winning Trading Venue Reviewer, which contains pre-prepared analysis of both exchanges' rules.

If you have been affected by this news or would like to know more, we'd love to hear from you.

IOSCO Report: Ins and Outages

As fate would have it, just before the above-mentioned crisis blew up, the International Organization of Securities Commissions (IOSCO) published its Final Report on Market Outages. This considers events including disruption and disorderly trading on trading venues, for example due to technical problems or operational issues. Such outages can be highly disruptive and have significant knock-on effects, hence the drive to scrutinise the problem at a global level.

Following a survey of 24 regulatory authorities in 2022, IOSCO has now published a lengthy summary of its key findings, rounded out with the following **five "good practices"** for listing trading venues to improve market-wide resilience:

- Publish an outage plan, which may cover communications, reopening, a closing auction arrangement and alternative closing price methodologies.
- Implement a communication plan, providing notice of the outage and regular updates on status.
- Communicate on reopening of trading, in a timely manner, to all market participants.
- Publish and communicate procedures for a closing auction and for establishing alternative closing prices.
- Conduct a post mortem and adopt a post-outage plan, sharing lessons learnt with regulators.

These "good practice" recommendations are **principles-based**, and it is for individual trading venues to determine how best to implement them, subject to domestic legal and regulatory requirements. It's worth noting that we're in the midst of major developments regarding such domestic requirements, as **operational resilience** has moved ever upwards on the regulatory agenda:

- In the EU, we have the Digital Operational Resilience Act (DORA), which came into force in January 2023 and will apply from January 2025. In May 2023, ESMA also published a Final Report on Market Outages, and IOSCO position their own report as guidance on the requirements to be imposed on trading venues by EU national competent authorities.
- Meanwhile, in the UK, a March 2025 deadline is fast approaching for firms to map, test and invest in business tolerance improvements based on the FCA's 2021 Policy Statement on operational resilience. At the same time, the FCA has also (following yet another Policy Statement) established a committee to develop good practices during outages, which will consider IOSCO's guidance when its recommendations are reported later this year.

All of which presents a veritable feast for thought, for trading venues and their market participants!

Ancillary Activities EXTENSION

Another significant recent development – and one occasioning a significant sigh of relief for many – is the cancellation of recent proposals to replace the ancillary activities exemption (AAE) under the UK's MiFID regime.

To recap briefly how we got here: back in May 2023 HMT legislated to **revoke** the AAE and replace it with a **qualitative test supported by FCA guidance**. Those changes were due to come into effect at the start of 2025. In December 2023, the FCA issued proposals as part of CP23/27 which included guidance intended to clarify how the AAE should be applied.

You may recall we mentioned in the March edition of Markets View that we collaborated with the FIA to help draft their response to the FCA's proposals. We saw a clear consensus among members that the FCA needed urgently to engage with HMT to provide more time and to address concerns – the key problem being that the proposed approach, being a qualitative test supported by FCA guidance in PERG, did not offer firms the **legal certainty** that they need in order to get comfortable relying on the exemption.

Well, we now have the response. The relevant legislation has been revised to **omit** prospective amendments to the AAE, and the FCA announced that it will **delay** revoking the AAE and will not take forward the related proposals it made in CP23/27. HMT and the FCA are now working on revising their approach, and are targeting an implementation date of **01 January 2027** for whatever new regime they devise between them.

For now, then, firms can continue to rely on the AAE in its current guise. However, it won't be around indefinitely, so we'll be keeping watch for further developments in this space.

UK General Election – Eyes on Carbon Markets

With the UK general election now only days away, we can't ignore the potential consequences for UK market regulation. You may have tuned in to this week's **podcast** where, in view of recent opinion polls, our very own Alex Ainley provided an overview of the potential implications of the Labour party manifesto – including the comment from Shadow Chancellor Rachel Reeves that it's "*time to ditch the government fixation on regulatory divergence*". You can listen to that recording here.

Beyond the above, though, one area that's potentially ripe for change is the UK Emissions Trading Scheme (UK ETS). The Financial Times reported in a recent article that Labour, if elected, intend to **align the UK ETS with the EU's ETS**. The idea of re-linking the two goes all the way back to the UK and EU's Trade and Cooperation Agreement, but this is the first indication we've had that it might actually bear fruit. Such a linkage would present practical as well as political challenges at this stage, given the various points of divergence between the two ETSs over the last couple of years. Nevertheless, it could offer significant benefits in terms of market liquidity and stability.

Furthermore, it is reported that Labour would also seek to align the UK with the EU's "**CBAM**", which is the tax due to be imposed on imported goods (such as steel) from 2026, based on the costs imposed for the carbon emitted during their production (relative to the price of emission allowances under EU ETS). The UK recently launched plans for a CBAM of its own, which is expected to come into force in 2027. That 1-year gap between the EU and UK roll-out is perceived as a potential risk in terms of making the UK a "*temporary dumping ground*" for goods that become subject to the new EU CBAM. For that reason, Labour would reportedly look to bring the timing of the two into sync. Meanwhile, the alignment of the two ETSs, by creating a standardised cost of carbon across the UK and EU, should obviate the threat that the EU CBAM whacks a 'top up' cost on UK exporters to the bloc based on the difference in allowance prices (which is currently significant).

Needless to say, we will be watching closely to see what happens after 04 July.

UK ETS: Waste Not, Emit Not

Sticking with UK ETS: the government recently published a "package" of Consultation Papers on expanding the scheme, as anticipated in our Summer 2023 edition of Markets View. These papers focus on how the (1) **energy from waste / waste incineration schemes**, and (2) **engineered Greenhouse Gas Removals** ("GGRs", sometimes called "negative emissions") such as carbon capture schemes, could be accounted for in the existing ETS framework.

Regarding the proposals for expanding the UK ETS to include waste / waste incineration, the Consultation Paper, which closes for comments on the 02 August, invites answers to a series of questions relating to environmental schemes involving the incineration and combustion of waste, along with other energy recovery systems.

The second Consultation Paper, meanwhile, invites answers to a range of issues around integrating GGRs into the UK ETS. You may recall that we recently looked at the European perspective on this in the March edition of Markets View. The UK and EU are clearly thinking along similar lines on a number of issues here, and have identified some similar thorny issues – for example around pricing.

One key consideration on both sides will be how GGRs would fit with the existing (net zero-aligned) cap on emission allowances: on this front, we note the UK's paper settles on a preferred option of maintaining the gross cap and calculating GGRs as a negative against gross emissions (i.e. a UK emissions allowance would be replaced every time a GGR allowance is issued), while the EU has not settled on a single proposal yet (and

indeed the Commission is not required to come to a decision until 2026). This second paper closes for comments on 15 August.

It's worth flagging that we're expecting two further consultation papers on UK ETS in due course, which will address expansion toc cover the domestic maritime sector from 2026, and potential recognition of non-pipeline methods for moving captured CO2 into storage (which is currently the subject of an open call for evidence).

New Clearing Model: All You Can EATM

The FIA unveiled a new UK and EU client clearing model – the **European Agent Trustee Model**, or "EATM" – at an event last week. In essence, this seeks to mimic the **US futures commission merchant** model as far as possible, and thereby improve firms' clearing options.

The main clearing model in Europe at the moment is the "riskless principal" model, whereby clearing banks have back-to-back transactions with both the client and the CCP. We understand this presents a problem in relation to capital charges for those FCMs who are global systemically important banks (or "G-Sibs") and so is perceived as a disincentive to offering client clearing services.

The EATM seeks to fix this by offering an alternative, agency-based model, whereby the transaction is between the client and the CCP – hence the reference to 'agent' in the name. The reference to 'trustee' reflects the use of either an English common law trust or German law trust to structure the arrangement. Unsurprisingly, this use of a trust structure is where the complexity starts to creep in. We have some detail on the planned English law arrangements, which both **Eurex Clearing** and **LCH** are gearing up to start offering to their UK clearing members, but the European (German law) piece is still being worked on.

Overall, this announcement potentially represents the start of a significant shift in UK and European clearing practices. However, don't expect this to happen fast – the immediate focus is limited to clearing members clearing certain OTC trades for direct clients at only a couple of CCPs. It's certainly going to be an interesting space to watch.

Bringing Up Short-Sellers: New Fines from Consob

And finally…a short-selling case that caught our eye. You may have seen that Consob, Italy's financial regulator, has fined two Dutch high-frequency traders for illegally short selling shares in **Saipem**, an Italian oilfield services company, during its failed capital increase exercise in 2022. Optiver and Flow Traders, both Dutch proprietary trading firms and market makers, were **fined a combined EUR 4.7m** and ordered respectively to repay EUR 2.7m and EUR 2.2m in profits, for betting on stocks falling without borrowing them in advance – so-called "naked short selling".

The two companies did not notify Consob or the market of their short positions as required under Article 5 of the EU Short Selling Regulation, when the positions reached 0.5% of the issued share capital of Saipem. Optiver traded nearly 45% of Saipem's share capital in two days, and Flow Traders traded over 7% of Saipem's share capital on one day.

Optiver is reportedly considering an appeal, as it believes the transactions were covered by the market-making exemption, under Article 17 of the Short Selling Regulation.

That's all for this edition – we wish you all a good weekend to come!

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