

tough objectives they now have are also positive.

However, the number and extent of the changes is unprecedented. Given all of the uncertainty they engender, time is needed to assess impacts. We need to make the changes which have been put in to effect work. For example, it is reported that the quality of the data set from the EMIR reporting remains unsatisfactory and yet it is supposed to be the basis of so much which is of key importance. Also, I recall that the data was intended to be used to provide market, as well as regulatory,

transparency. This should be achieved before new reforms are advanced.

Further, where negative unintended consequences emerge, the community should respond quickly and make changes to correct them.

Conclusion

The financial services sector must accept the need to repair public confidence and accept the utility of many of the reforms. Every participant, including those in the commodity sector, should embrace constructive compliance. Energy markets do,

however, fulfil a vital role and it is right that where we see negative consequences, we must highlight them and work hard to seek understanding. We need to do this to ensure they are put right, in order to safeguard investment in the EU and to encourage energy businesses worldwide to continue to view the EU as an attractive region in which to do business. This is for the good of our economies, our consumers, and our quality of life.

This article is written in the author's personal capacity and should not be taken as reflecting BP's views.



A new regulatory paradigm for EU commodity markets

Jonathan Farrimond and Paul Wightman

From 3 January 2017, Europe's financial commodity markets will march to a different regulatory beat. The recast MiFID II (Markets in Financial Instruments Directive) and its sister regulation MiFIR (Markets in Financial Instruments Regulation) have, remarkably, been over five years in the making. But upon implementation, they are set to introduce sweeping changes to the structure and workings of EU financial commodity markets – or rather, the entire European Economic Area (EEA), as the legislation has 'EEA relevance' – impacting participants, trading venues, and regulators alike.

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**'THE POLITICAL INTENT IS CLEAR:
 TO BRING MORE COMMODITY FIRMS
 DIRECTLY INTO FINANCIAL REGULATION.'**

Many commodity firms with physical operations that are currently engaged in derivative trading but exempt from financial regulation face the spectre of being authorized, and therefore directly regulated, for the first time. This is because MiFID II will sweep away the

'commodity dealer exemption' available under MiFID I whilst at the same time significantly narrowing the current 'ancillary activities' exemption. The political intent is clear: to bring more commodity firms directly into financial regulation.

There are notable implications for a commodities firm becoming MiFID-authorized. In addition to the new organizational requirements and certain direct obligations to comply with, there would be consequential effects under a raft of other EU financial regulations. For example, under EMIR (European Markets Infrastructure Regulation) authorized firms cannot qualify for 'non-financial counterparty' status, regardless of whether they are active in physical commodity markets or not, and thereby lose significant relief from potentially onerous EMIR requirements such as mandatory clearing of over-the-counter (OTC) derivative contracts and wide-ranging risk mitigation techniques.

But it is capital requirements that have commodity firms most worried. CRD IV/

CRR (Capital Requirements Directive IV / Capital Requirements Regulation) is legislation designed to ensure that banks and other financial firms hold financial resources sufficient to protect against losses relevant to the business risks they face. Whilst most specialist commodity firms authorized under MiFID II would benefit from certain exemptions from CRD IV/CRR, related to 'large exposures' and regulatory capital treatment, these exemptions are due to expire at the end of 2017, and in any event these are not blanket exemptions; liquidity rules and 'Pillar 3' requirements (including remuneration code requirements) would still apply, as well as potentially other capital requirements in a firm's home jurisdiction.

The cost implications for individually affected firms could be huge. Whilst the exact impact can't yet be quantified, warning bells are beginning to sound from certain quarters. EFET (the European Federation of Energy Traders) suggested in a press release dated 16 April 2015 ('EFET calls for



action to prevent unintended consequences of financial market regulation for the European energy market in developing MiFID II Level 2 measures') that trading activities in certain energy markets could either be reduced or migrate to non-financial markets in the face of the prospective cost increases. Individual companies have made similar remarks.

Yet these are only possible outcomes, they are not foregone conclusions. Indeed, a more proportionate capital regime may yet emerge. The European Commission has until the end of 2015 to produce a report and a possible legislative proposal regarding capital requirements for firms that trade exclusively in commodity derivatives. There has even been talk in the industry that the expiry of the two key CRR exemptions might be pushed back to 2020. Until this happens though, affected firms will be looking on nervously.

EU trading venues will also be impacted by changes brought about by MiFID II/MiFIR. Whilst these venues will still continue to provide the market with a compelling offering – a central place to manage risk in a transparent and, where relevant, cleared manner – there will also be changes to the current model, a new environment to adapt to. The most notable of these changes is with respect to position limits, which is a new concept for European commodity markets. This will be the focus for the remainder of the article.

For the USA, position limits are not a new concept. The CFTC (Commodity Futures Trading Commission) has for decades directly imposed limits on a core set of agricultural contracts, and also effectively required exchanges to set limits across a broad swathe of other commodity and financial contracts. The origin of position limits in the USA dates back as far as 1936 with

powers to set the limits being granted to the CFTC's predecessor, the CEC (Commodity Exchange Commission), under the Commodity Exchange Act. The CEC first imposed position limits in 1938 on certain grain contracts.

In the case of the EU, however, with a few recent exceptions aside, regulators and exchanges have largely eschewed position limits in commodity derivative markets in favour of a less formalized, though by no means necessarily a less rigorous or less effective, approach. In the UK for example, the body responsible for the oversight and supervision of commodity derivative exchanges, the FCA (Financial Conduct Authority), has required exchanges to employ a 'position management' regime under which positions taken in their markets are scrutinized and, to the extent such positions have the potential to lead to disorderly settlement or be used to effect an abusive strategy, are appropriately managed. For instance, in certain cases positions could be capped or reduced at the direction of an exchange and in accordance with the authority set out in its own rulebook.

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'IT IS REGULATORS ... THAT WILL DETERMINE THE MAXIMUM ACCEPTABLE "SPECULATIVE" POSITION IN ANY GIVEN COMMODITY DERIVATIVE ...'
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The new MiFID framework will change the emphasis of this current arrangement. Whilst the new regulations will require exchanges and other trading venues in the EU that list commodity derivatives to operate effective position management controls, this will be overlaid with an all-encompassing position limit regime. This is a significant change. It is regulators across the EU that will determine the maximum acceptable 'speculative' position in any given commodity derivative, not the trading venues. These maximum levels will be hard limits, applying to both the spot

month and 'all other months', which participants will not be permitted to exceed unless they hold a relevant exemption, granted for hedging activity only.

Hedge exemptions will only be granted to 'non-financial firms', effectively defined as firms that do not carry some form of financial market authorization under European legislation. This would therefore preclude commercial firms that carried a MiFID licence, as well as other financial firms, such as banks, from utilizing hedge exemptions. This could be problematic in some cases. It is not yet clear how affected commercial firms may respond to this challenge. For banks in the EU, they will need to assess how OTC commercial client business that is presently hedged with on-exchange derivatives could be affected.

The challenges in transitioning to this new regime are magnified by the scope and ambition shown by MiFID's co-legislators. Position limits will apply to all commodity derivative contracts traded on a trading venue – whether that be, in European jargon, regulated markets (in other words, exchanges), multilateral trading facilities (MTFs), or the as yet unknown pool of participants to be classed as organized trading facilities (OTFs) – as well as derivative contracts trading in the OTC market deemed to be economically equivalent to any of those on-venue contracts.

Implementation risk is therefore high. To move from a regulatory framework which has largely excluded the use of position limits (barring a few recent introductions of exchange-administered delivery and expiry limits), to a place where position limits apply to the vast majority of commodity derivatives in the EU, is a bold move. Regulators face a gargantuan task in accurately setting appropriate limits for the potentially thousands of affected contracts simultaneously, and must therefore

remain open to amending these initial limits in light of practical experience as the case may require.

The scope of the regime will presumably also result in a prosecutorial shift, with national regulators in the EU likely to take a leading role in prosecuting limit breaches. In the normal course of events, generally speaking it is the exchanges that enforce against minor rule infractions, whereas enforcement action taken by national regulators is usually reserved for more high profile and egregious misconduct, such as serious market abuse cases.

Yet this will surely have to change, at least in certain cases. This is because position limits will apply to on-venue contracts and economically equivalent OTC contracts. Trading venues will simply not have sight of positions in OTC contracts, and in such cases compliance with limits will have to be assessed by national regulators with appropriate access to position data, potentially across different EU jurisdictions. The picture could be further complicated if one position limit was to be applied to more than one on-venue contract, as the legislation seems to envisage in certain cases. The quality of information flows between the exchanges and national regulators, and between national regulators themselves, is therefore going to be critical if policing and enforcement of position limits is to be completely effective.

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‘CLEARING FIRMS THAT OPERATE ON A PAN-EUROPEAN LEVEL ARE LIKELY TO HAVE TO BEAR SIGNIFICANT EXTRA COSTS AND INVESTMENT.’

There are also system build implications and cost outlays to consider. For market participants, their systems must be sophisticated enough to assess compliance with limits across

potentially thousands of contracts in real time, discounting hedging activity where relevant and aggregating positions across contracts and group entities in appropriate cases. Position reporting capabilities will also have to be enhanced. Whilst many participants already report positions to certain exchanges, the MiFID position reporting regime is far more extensive, requiring reports to be sent to all venues where open commodity derivative positions are held, and for some firms reports must also be sent directly to national regulators. Clearing firms that operate on a pan-European level are likely to have to bear significant extra costs and investment. It is not clear whether such costs could be easily passed onto each client in an environment where the cost of clearing is already rising significantly. Trading venues and regulators must also have adequate systems enabling them to receive and make use of position data in MiFID-compliant formats.

In addition to the overarching requirements set out directly in the MiFID II/MiFIR legislation, ESMA (the European Securities and Markets Authority) has recently published the detailed rules required for implementation in the form of draft Regulatory Technical Standards (RTS). Whilst the RTS remain subject to the review and approval of the EU Commission, Council, and Parliament, they do give a very good indication as to how some of the mechanics of the regime will work in practice. There are a number of features to ESMA's proposed regime that are worthy of comment.

First, ESMA's methodology which national regulators will use to calculate position limit levels on commodity derivative contracts in their jurisdiction is, broadly speaking, a sensible framework. ESMA's methodology addresses the risk of abusive squeezes occurring as derivative

contracts approach expiry, by capping spot month derivative positions to a proportion of overall physical market supply (except for contracts where this isn't a relevant concept, such as weather, where position will be capped as a proportion of open interest). However, the usefulness of an 'all other months' limit is less obvious, as the risk of an abusive squeeze occurring outside the spot month is far less likely to occur. Nonetheless, such limits are required by the legislation. ESMA's proposal to cap the 'all other months' positions to a proportion of overall market liquidity, subject to a *de minimis* threshold to ensure limits do not artificially stymie the growth of new and illiquid contracts, is therefore probably the best way of calibrating the framework given the constraints of the legislation.

There is also flexibility built into the methodology – a sensible step when limits will apply to so many and so varied a set of contracts. Having first calculated a baseline limit of 25 per cent of either deliverable supply or open interest, regulators will have the power to amend that limit, either upwards to a maximum of 35 per cent or downwards to a minimum of 5 per cent, after assessing a range of factors relevant to that specific contract.

Yet the benefits afforded by this flexibility come with a caveat: regulatory discretion in the setting of the limits needs to be wielded with due skill, care, and caution. Setting limits too low could unnecessarily constrain legitimate trading activity – clearly a negative outcome. Yet even where higher limits are established, circumspection will still be needed to ensure markets remain orderly and free from abusive practices; position limits should never negate continual and effective use of position management powers by exchanges and other similar venues.



Second, parts of ESMA’s commentary on the factors that could drive the position limit upwards or downwards from the baseline level are data driven, and trading venues should therefore be braced for multiple data and information requests. This would be particularly welcome in respect of assessing the level of deliverable supply relevant to a contract, with certain trading venues holding significant expertise in this area. Whilst the draft RTS do not appear to oblige national regulators to consult trading venues for deliverable supply estimates, ESMA’s Final Report on the draft RTS indicates this is certainly contemplated and it is something therefore we believe is likely to happen in practice. However, in the interests of transparency and integrity, any deliverable supply estimates provided by trading venues to regulators should be as a general principle a matter of public record, as is the case in the USA, except perhaps in cases where proprietary data of a third party is used.

Third, it would appear that spot month position limits will apply to a contract for as long as it is deemed to be ‘the spot month’. This is different to how the regime has typically worked in US markets, where the spot month limit only applies for a certain period, such as the last three business days prior to expiry. Under the EU regime though, ESMA has defined the spot month contract as ‘the next contract in that commodity derivative to mature’. Absent any clarification it would appear the spot month limit will apply the moment a contract becomes designated as ‘the spot month’ and will remain in force until the contract expires. Depending on where specific position limit levels are set by national regulators this could prove to be significant and it becomes more notable for contracts with less frequent listings – for contracts with

longer-dated expiry structures, such as quarterly expiries that are common to certain agricultural contracts, the spot month limit would apply to the same ‘spot month’ contract for three months.

Fourth, ESMA has drawn the definition of economically equivalent OTC (EEOTC) contracts narrowly. OTC contracts will be caught by limits if they have ‘identical contract specifications and terms and conditions’ to on-venue contracts (though the definition specifically excludes ‘post-trade risk management arrangements’ as a necessary factor). A related recital also requires an OTC contract to have the ‘same underlying commodity that is deliverable at the same location’ as an on-venue contract. ESMA’s intention appears to be to reduce the complexity of applying position limits to a diverse and somewhat unknown set of contracts in the OTC market. Yet it remains to be seen as to whether this will be the case in practice, and much will hang on how regulators and the market will interpret the term ‘identical’. For example, OTC contracts are typically governed by agreements that contain terms and conditions that do not appear in the terms and conditions for trading in on-venue contracts – will that difference mean that ESMA’s OTC definition effectively becomes an empty set?

Assuming at least some OTC contracts could be found to be equivalent to on-venue contracts, the question then arises as to whether the market could establish with certainty what an EEOTC contract is – a fundamental prerequisite for participants to adhere to position limit levels and for regulators to validate firms are compliant. It would appear that a definitive public list would be the optimum way of achieving this necessary certainty. Participants could be asked to notify regulators of the OTC contracts they deem to be economically equivalent to on-venue

contracts. Subject to assessment and approval by regulators, these contracts would then be added to a public list. This would be a partial solution, but other complexities also need clarifying, such as whether an OTC contract could be economically equivalent to more than one on-venue contract, and how OTC contracts with pricing structures that don’t neatly map to on-venue expiry and pricing structures should be treated. Such questions may be moot, however, if the currently proposed narrow EEOTC definition is retained and passed into European law.

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‘ESMA’S NARROW DEFINITION OF THE “SAME” COMMODITY DERIVATIVE MEANS THAT IN MOST CASES EACH CONTRACT ... WILL BE GOVERNED BY A SEPARATE LIMIT.’

Fifth, ESMA’s narrow definition of the ‘same’ commodity derivative means that in most cases each contract in the EU will be governed by a separate limit. MiFID II requires that where the ‘same’ commodity derivative is traded in significant volumes on trading venues in more than one EU Member State, those contracts should share the same limit. However, ESMA’s definition of ‘same’ in this context is very narrow – based on the EEOTC definition previously referenced and a requirement that the two contracts ‘form a single fungible pool of open interest’. The latter clause appears to mean that one contract may be closed out by trading a second contract. Very few, if any, contracts traded across multiple venues are, in our view, likely to meet this requirement. The net effect is that under the current market structure it is highly unlikely contracts traded on different venues will be governed by the same limit. There is therefore an apparent disconnect between the policy intent of the co-legislators and ESMA’s proposal on this point.

But what of cases where two or more of the 'same' contracts are traded across multiple venues in a *single* EU Member State? Whilst the MiFID II legislation is silent on this point, it would appear ESMA's proposed rules would require positions in such contracts to be aggregated too. However, again, the narrowness of the definition of 'same' would seem to preclude that as a realistic possibility. It would also appear that where similar (but not the same) contracts are traded on the same venue, such as options and related futures, or 'mini-sized' and related 'main' contracts, there is arguably no requirement to aggregate positions in such contracts (although trading venues could still aggregate positions in such contracts for their own monitoring and surveillance purposes).

The narrowness of the definition of 'same' commodity derivative could pose headaches for regulators when determining appropriate limit sizes. This resonates most in markets that are fragmented, and European power and gas markets are a good case in point. There are multiple exchanges and broker platforms active in these markets in Europe with substantially similar contracts offerings, all of which will be caught by the EU-wide position limits regime. Whilst market participants may see many of these gas and power contracts as substantially similar in economic terms, or even identical in certain cases, they are unlikely to be classed as the 'same' for position limit purposes.

A potential problem could therefore arise as to how limits will be set for each of these similar contracts. Let's assume that national regulators determine the appropriate spot month limit in a European gas contract should be set at 25 per cent of deliverable supply. Will each contract on separate venues be allocated a limit of 25 per cent of deliverable supply? Or will each of those venues proportionally share

of an overall limit, such as 2.5 per cent of deliverable supply shared equally amongst ten venues? Neither scenario provides an optimal outcome.

Sixth, the proposals on aggregating positions across a group are not clear. Barring a carve-out for qualifying investment managers, the regime requires a 'parent undertaking' to aggregate its own positions with each of its 'subsidiary undertaking' firms. The definition as to what constitutes parent and subsidiary undertakings is found in the Consolidated Accounts Directive (2013/34/EU) – the relationship being triggered in scenarios where a parent holds a majority of the voting rights of a subsidiary, or breaches one of a number of tests related to control over the governance framework of a subsidiary (such as powers to appoint or remove Board members and management).

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'... THE AGGREGATION STANDARD SHOULD ADDRESS BOTH THE CORPORATE RELATIONSHIP BETWEEN ENTITIES AND TRADING CONTROL.'

ESMA specifically states in its Final Report that the aggregation standard should address both the corporate relationship between entities and trading control. However, the Accounting Directive tests are not designed to measure, and therefore completely ignore, whether or not one group entity exercises *trading control* over the derivative positions of another group entity. Consequently, it could be possible in certain cases that an entity is required to aggregate its derivative positions with those of another entity within the same group over which it has no direct knowledge or control. This could obviously be problematic from a compliance standpoint, as how would two sister companies that are deliberately separated by location and firewalls, for example, know whether their combined positions were in

compliance with a given limit? It is also not clear whether aggregation merely occurs from the topmost position holder downwards (as seems to have been ESMA's intention from previous consultations) or whether aggregation is also meant to occur 'upwards' through a corporate structure. Further guidance from ESMA will be needed to ensure a clear and consistent interpretation on the standards for aggregation.

Seventh, the workability of the process for obtaining a hedge exemption regime is questionable. Leaving aside the implications of banks and other financial institutions being ineligible for hedge exemptions (a MiFID legislative issue that ESMA cannot fix), ESMA has proposed that national regulators be permitted 21 days to consider each hedge exemption request – an impossible wait if business risks require hedging immediately – with no ability to file exemptions *ex post*, even in limited necessary cases. Commercial firms could therefore face difficult decisions as to how to manage specific price risk of a physical commodity when faced with immediate hedging requirements, which could include seeking access to markets without such constraints or where hedge exemptions may be more easily obtained.

It also appears ESMA's proposals could require firms to apply to national regulators on a position-by-position basis, as the draft RTS seems to require relevant firms to demonstrate how a *position* reduces risk directly relating to their commercial activity in order to obtain a hedge exemption. Such an approach could see regulators swamped with requests and aggravate the inefficiency of the strict 21 calendar day process. A more workable approach would be to allow national regulators to grant hedge exemptions based on the likely or possible commercial activity of a firm over a certain forward looking duration,

