

financial end-users via higher spreads etc., this could have implications for the real economy. Expressed differently, the heightened hedging costs of financial and non-financial firms may lead to unhedged positions and thereby more volatile balance sheets and subdued investment levels.

Uncertainty regarding the hedging criteria in Europe

Taking into account the potential side effects of the new regulatory reforms on the real economy, regulators on both sides of the Atlantic have introduced central clearing exemptions for non-financial counterparties (NFCs) that engage in derivatives transactions to hedge or mitigate commercial risk. For example, NFCs are not subject to the mandatory central clearing requirement under EMIR on the

condition that notional amounts of their derivatives trades are below certain thresholds. Notwithstanding, the European Securities and Markets Authority (ESMA) has recently released a report recommending the removal of the hedging criteria for NFCs. The background reason is to simplify NFC definition along with the fact that hedging may not be the most relevant criterion in determining the systemic relevance of NFCs. However, the exemptions for NFCs that hedge a commercial risk are particularly important for the commodity derivatives segment, considering that NFCs are vital and important market participants. More specifically, another report from ESMA shows that among different OTC derivatives the share of the NFCs is the largest in commodity derivatives: they account for one-fifth of the gross notional amounts traded. Of these,

80 per cent are below the threshold defined by EMIR. In this light, changes in the hedging criteria as recently recommended may have negative consequences for NFCs that trade commodity derivatives.

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'... THE NEW RULES AND REGULATIONS WILL FUNDAMENTALLY CHANGE THE DERIVATIVES MARKETS ...'

All in all, the new rules and regulations will fundamentally change the derivatives markets after their full implementation. It remains to be seen to what extent they will affect the pricing, liquidity, and trading of commodity derivatives.

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MiFID II: the impact on commodity markets from a venue perspective

Ben Pott and Graham Francis

Commodity derivative markets have been a cornerstone of modern financial services since the Big Bang in 1986. The ability of end-users to hedge their commodity exposures and anticipate price movements has ultimately had a stabilizing effect on end-user prices and, together with deepening liquidity in these markets, has led to tighter bid-offer spreads, again leading to reduced costs for the end-users. This link between end-users and financial trading is perhaps unique in financial markets. It means that changes to the trading landscape can have direct consequences on the price at the pump, or on the household energy bill at the end of the month.

However, commodity markets – like any other financial market – have not been

immune to the effects of the 2008 crisis. Over-extension and a speculative bubble have led to market participants' failure, with knock-on consequences for investors. Whereas other markets have experienced a withdrawal of liquidity as banks had to rein in their trading books, the commodity sector has seen a more dramatic change in participation – away from the traditional broker dealer banks towards trading houses, often based outside of the European Union perimeter.

However, commodity markets today are still experiencing the turmoil of the post-

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'... COMMODITY MARKETS TODAY ARE STILL EXPERIENCING THE TURMOIL OF THE POST-CRISIS REGULATORY REFORM PROGRAMME.'

crisis regulatory reform programme. Whereas bank reform has changed the face of participation, it is market-specific reform – Market in Financial Instruments Directive (MiFID) II – which will have a more profound impact on the intermediated commodity markets. This paper sets out not just the future challenges faced by participants but also focuses specifically on the reorganization and reshaping that is required by these intermediaries – today's brokers and trading venues.

Background

MiFID II will be a key milestone in commodities trading markets. The requirements to trade on venues (trading obligation), together with the organizational requirements on



The key differences between MTFs and OTFs		
	Multilateral trading facility (MTF)	Organized trading facility (OTF)
Product coverage	All financial instrument	Non-equities only
Type of execution	Non-discretionary only	Discretionary
Restrictions	Cannot execute against own capital or matched principal	Cannot execute against own capital but can operate as matched principal
Participation	Authorized participants only	Can be unregulated
Conduct requirements	Limited application	Full applicability of conduct requirements including best execution

intermediaries to trade as a trading venue – either a multilateral trading facility (MTF) without discretion or an organized trading facility (OTF) with discretion in execution – as well as the extension of the scope of participants beyond the core financial counterparties, will all lead to a significantly different trading landscape come 2017. For commodities markets specifically, the key changes will bring firms with significant ancillary trading activities into scope, and introduce a novel position limits regime. It will also carve up wholesale energy markets between financial markets and non-financial markets, traded only on OTFs or bilateral, and in products that ‘must physically settle’.

Drawing a wider perimeter of regulated firms

Much has been written about the commodities firms coming into scope by losing their MiFID I exemptions – including blanket exemptions for commodity dealers and firms trading on their own account. In combination with the expiration of Capital Requirements Directive (CRD) IV exemption from capital requirements for commodity dealers in late 2017, the impact on corporate users of commodity derivatives will be significant. Some have estimated the total cost impact to be in the region of £ billions – including Shell which stated that the total

additional regulatory capital they would have to hold would be in the region of USD 30 billion (see the article ‘EU traders and energy groups braced for MiFID II guidance’ by Neil Hume, 23 September 2015, *Financial Times*).

Worse still, firms may not have much time to prepare for this regulatory tsunami. Whilst the technical standards now allow for an enhanced monitoring period from July 2015 to 30 June 2016, and a starting date for notifying the competent authorities by 1 July 2017, total market size is still unknown and will be difficult to obtain. Even then, firms will have to seek recognition from their regulatory authorities, which is likely to take at least six months. Consequently, participants won’t be in a position to know if the market

test takes them outside of MiFID II, but will instead need to prepare for MiFID II rules by taking a conservative view – whether they are likely to breach the volume thresholds set out in the regulatory standards (see below) or not.

In addition, there are concerns that the current main business activity test is too narrowly focused on trading activity – the test will see firms calculate their position in derivatives and EU allowances, and measure this against their overall position. This will then give a percentage figure which represents how much of their trade is proprietary or speculative. Many in the industry believe that this test does not reflect the political agreement for MiFID II, which was meant to measure trading activity against the whole business of a company, not just its trading activity.

OTFs – commodity brokers of the future

From a venue perspective, the issue of classifying customers is less relevant. The key challenges are of an altogether different nature.

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‘THE VENUE CLASSIFICATION HAS AN ULTIMATE BEARING ON THE NATURE OF THE INSTRUMENT BEING TRADED.’

Firstly, the venue classification has an

Volume thresholds set out in the MiFID II regulatory standards	
Product	% threshold
Derivatives on metals	4%
Derivatives on oil and oil products	3%
Derivatives on coal	10%
Derivatives on gas	3%
Derivatives on power	6%
Derivatives on agricultural products	4%
Derivatives on other commodities, including freight and commodities referred to in Section C 10 of Annex I to Directive 2014/65/EU	15%
Emission allowances or derivatives thereof	20%

ultimate bearing on the nature of the instrument being traded. Venues holding themselves out to be MTFs will soon discover participants in wholesale energy products asking for an OTF licence. This is simply because, at that point, certain wholesale energy products fall outside the scope of MiFID and inside that of REMIT (the Regulation on Energy Market Integrity and Transparency). Only OTF wholesale energy products fall outside the definition of a 'financial instrument'. Whilst REMIT still requires reporting of

transactions and monitoring for abuse, the set of requirements is less onerous. Even more significantly, REMIT transactions do not count towards the MiFID II ancillary activities thresholds which, in turn, may keep a firm outside of MiFID II and associated CRD IV requirements.

The majority of organizational requirements would still apply to an OTF, such as market monitoring, access requirements and, potentially, algo testing requirements (if required).

However, pre- and post-trade requirements, trading obligations, position limits, and best execution reporting requirements would not apply – a major incentive for participants to deal in wholesale energy products that are outside of the financial instrument definition.

Transparency calibrations

Secondly, venues will have to abide by a host of transparency requirements, both pre- and post-trade, depending

Energy commodity futures / forwards				Each sub-class shall be determined not to have a liquid market as per Articles 6 and 8(1)(b) if it does not meet one or all of the following thresholds of the quantitative liquidity criteria	Average daily notional amount (ADNA) [quantitative liquidity criterion 1]	Average daily number of trades [quantitative liquidity criterion 2]
For the purpose of the determination of the classes of financial instruments considered not to have a liquid market as per Articles 6 and 8(1)(b), each sub-asset class shall be further segmented into sub-classes as defined below						
An energy commodity future/forward sub-class is defined by the following segmentation criteria: Segmentation criterion 1 – energy type: oil, oil distillates, coal, oil light ends, natural gas, electricity, inter-energy 2 – underlying energy 3 – notional currency defined as the currency in which the notional amount of the future/forward is denominated 4 – load type defined as baseload, peakload, off-peak or others, applicable to energy type: electricity 5 – delivery/ cash settlement location applicable to energy types: oil, oil distillates, oil light ends, electricity, inter-energy 6 – time to maturity bucket of the future/forward defined as follows:				EUR 10,000,000	10	
Maturity bucket	Oil/ oil distillates/ oil light ends	Coal	Natural gas/ electricity/ inter-energy			
1	0 < time to maturity ≤ 4 months	0 < time to maturity ≤ 6 months	0 < time to maturity ≤ 1 month			
2	4 months < time to maturity ≤ 8 months	6 months < time to maturity ≤ 1 year	1 month < time to maturity ≤ 1 year			
3	8 months < time to maturity ≤ 1 year	1 year < time to maturity ≤ 2 years	1 year < time to maturity ≤ 2 years			
4	1 year < time to maturity ≤ 2 years					
m	(n-1) years < time to maturity ≤ n years	(n-1) years < time to maturity ≤ n years	(n-1) years < time to maturity ≤ n years			



on the nature of the instrument (liquid vs illiquid) and the size of the order transmitted (greater or smaller than 'large in scale') – the latter being the equivalent of the well-known block-size thresholds in operation today. An additional threshold is available where products are traded by voice or by RFQ; where an order exceeds this size (specific to the instrument threshold) only indicative bids or offers have to be made pre-trade transparent.

This complex web of thresholds should have become clearer once the European Securities and Markets Authority (ESMA) published its regulatory technical standards in late September this year. Whereas block-size thresholds used to be set by the exchanges, they are now defined by the regulatory authorities. Initially, technical standards setting out liquidity determinations and size thresholds were expected by July but were then delayed until late September. One key challenge was (and still is) the lack of market data – a key factor that may have contributed to the draft thresholds in a December 2014 consultation paper

by ESMA being out of line with market expectations and practice.

The latest set of technical standards now sets out thresholds for determining whether a given product is indeed liquid. Products would only make that list if their average daily notional amount is above EUR 10 million or if they are traded more than 10 times per day on average. The table opposite, Energy commodity futures/forwards, lists the example of 'liquid' energy commodity futures as identified by ESMA.

To determine the 'large-in-scale' (LIS) and 'size specific to the instrument' (SSTI) thresholds, ESMA has opted for a percentile approach; in other words, setting expectations around how much trading of a given liquid product should take place at sizes below and above the thresholds. The table below, Percentiles and threshold floors, illustrates the case of energy commodity futures.

The hope now is that ESMA can find a suitably comprehensive data set – including both on exchange and over-the-counter (OTC) traded contracts – for the commodities markets, and

set thresholds that are more reflective of the current trading environment. In the absence of aggregating sufficiently high quality data, a phase-in approach may be appropriate. Given that MiFID II will introduce robust reporting requirements from 2018 onwards a more accurate calibration should be possible in time.

Getting the thresholds wrong could clearly have significant impact on the commodities markets; in particular it could damage liquidity in those markets and may result in trading in certain asset classes, especially where seaborne, being driven out of the EU.

Position reporting

Venue trading in Europe will also be impacted by the provisions on position reporting. MiFID II requires participants to report their and their clients' positions to the venue in order for the venue to publish aggregate positions and report onwards to the competent authorities a detailed position breakdown. The requirement is embedded in the legislative text itself

Percentiles and threshold floors (to be applied for the calculation of the pre-trade and post-trade SSTI and LIS thresholds for the sub-classes determined to have a liquid market)

Sub-asset class*	SSTI pre-trade		LIS pre-trade		SSTI post-trade			LIS post-trade		
	Trade – percentile	Threshold floor	Trade – percentile	Threshold floor	Trade – percentile	Volume – percentile	Threshold floor	Trade – percentile	Volume – percentile	Threshold floor
Energy commodity futures/forwards**	60	EUR 250,000	70	EUR 500,000	80	60	EUR 750,000	90	70	EUR 1,000,000
Energy commodity options**	60	EUR 250,000	70	EUR 500,000	80	60	EUR 750,000	90	70	EUR 1,000,000
Energy commodity swaps**	60	EUR 250,000	70	EUR 500,000	80	60	EUR 750,000	90	70	EUR 1,000,000
Agricultural commodity futures/forwards**	60	EUR 250,000	70	EUR 500,000	80	60	EUR 750,000	90	70	EUR 1,000,000

* Transactions to be considered for the calculations of the thresholds.

** Calculation of thresholds should be performed for each sub-class of the sub-asset class considering the transactions executed on financial instruments belonging to the sub-class.

and is no longer subject to review by ESMA or the competent authorities. However, the practicalities of the process could have a significant impact on commodities markets today.

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‘VENUE TRADING IN EUROPE WILL ALSO BE IMPACTED BY THE PROVISIONS ON POSITION REPORTING.’

Under the proposed rules, a venue – including brokers – would be in possession of the complete position breakdown of every single participant on any given day. This raises serious questions around data confidentiality, especially in markets where trading is fragmented across platforms. This issue becomes even more relevant for third-country firms; the obligation to report positions rests with the venue, but the likelihood of getting accurate information from firms that are outside the scope of MiFID II is likely to be remote.

Similar questions arise in the context of transaction reporting where the venues are required to report on behalf of non-MiFID firms but where the data is unavailable to the venue itself (fields currently include a short selling flag, decision- and trader identification, etc. ...).

If venues and brokers find themselves in a position where they are not able to get the position and transaction reporting information, the question of consequences will undoubtedly have to be answered. Taking a hard line and expelling participants from the venue will only result in reduced and potentially fragmented liquidity, ultimately harming end-users.

A more successful approach would be to require participants to self-report positions and, in the case of third-country participants, to find a mutual approach for cross-border recognition of trading firms, ensuring pooled liquidity can continue delivering best value for end-users.

Trading venues of the future

The future for inter-dealer brokers and other intermediaries in the commodities markets has been written – the path towards reorganizing as a trading venue is set. However, big question marks will have to be answered before the commodities’ space is ready for MiFID II.

Key is the setting of transparency thresholds and the liquidity calibration

– it will determine to what extent intermediation, in today’s sense of the word, can continue. If full pre-trade disclosure were to be required, many markets may well be starved of liquidity, and trading would migrate to dark pools in related assets, or move into third-country markets with lesser transparency requirements.

As highlighted, the organizational form of the venue itself will be dependent on the asset traded. In the case of wholesale energy products, some OTC-intermediated business may migrate to OTFs to make full use of the non-financial product definition.

Beyond those key points, much of what used to be determined by exchanges will now be set by regulatory authorities. And therein lies a risk – whereas a wrongly calibrated size threshold at one exchange might have encouraged traders to block their trades elsewhere, this is no longer possible. Now a wrongly calibrated size threshold which has to be applied across venues will result in the disappearance of liquidity.

Whatever happens next, and wherever these thresholds ultimately come out, the face of the commodities markets is set to change significantly.



Regulatory change: impact on major energy companies and challenges they face

Jonathan Hill

Introduction

The international policy response to the financial crisis in the 2000s has presented an extremely challenging agenda for the energy sector. On the whole, this challenge should be cautiously welcomed. Through these policy initiatives, society is demanding more of the financial services sector in

order to rebuild trust and to encourage improved market functioning in years to come. However, the energy sector should rightly look for, and assertively present, unintended consequences where it foresees them, as a means of constructive response. These concerns are: the result of commodity markets (including physical commodity markets) being made subject to the

same regulations as other financial markets, and the distinction between group funding activities for investment in exploration and production, from physical commodity trading.

Not systemic

The primary objective of the reforms, led by the G20 group of countries, has