WHITE PAPER

IMPACT OF MIFID II ON COMMODITY & ENERGY TRADING

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Introduction

Majority of the Commodity Trading and Energy Trading firms did not have the obligation to report under MiFID I relying on the broad exemptions. The amended MiFID II regulation which comes into force in January 2018 sets out to regulate the Commodity Trading firms that were earlier left unregulated by limiting the exemptions and broadening the scope of financial instruments along with an ambitious Position Limits regime. With overall regulatory spending of major banks set to touch **US$ 2 billion per year**[1]**,** this paper outlines the business and technology impact of MIFID II on the Commodity Trading firms.

MiFID I and Commodity and Energy Trading Firms

The first version of Markets In Financial Instruments Directive (MiFID I) was introduced in 2007 with an aim of integrating the EU financial markets and bringing in Financial stability by mitigating systemic risk, improving investor protection and ensuring good levels of transparency. Since 2007, the commodity market has grown both in volume and complexity and the number of participants dealing with Commodities has increased many fold. Trading volumes of Commodity and Energy derivative contracts rose by 22.6% in 2015 (over 2014) and now account for almost 19% of derivatives trading[2].

Even though MiFID I covers Commodities, it offers multiple exemptions (described below) for Commodity firms which has largely left them unregulated.

Commodity Dealer Exemption (Article 2.1 k) - Firms whose main business involves dealing in Commodities or Commodity Derivatives on their own account are defined as Commodity Dealers and were exempt from reporting under MiFID. A majority of Commodity firms benefitted due to this exemption.

Dealing on Own Account Exemption (Article 2.1 d) - Firms dealing on own account in Commodities are exempt under MiFID I provided they don't trade outside a RM or MTF and is not a Market Maker

Ancillary Activity Exemption (Article 2.1 l) - Firms dealing on own account in Financial Instruments including Commodity derivatives are exempt under MiFID I provided it is ancillary to its main business. Most of the Commodity firms had exempted themselves using this provision as MiFID I does not mandate Quantitative tests .

1. Ernst & Young , 2014 : Adapting to the challenges of multiple regulations, London , Ernst & Young Publication
2. Will Acworth, March 2016 - Market Voice Magazine : Annual Survey Global Derivatives Volume http://marketvoicemag.org/?q=content/2015-annual-survey-global-derivatives-volume#top

Note: MTF: Multi-Lateral Trading Facility; RM: Regulated Markets

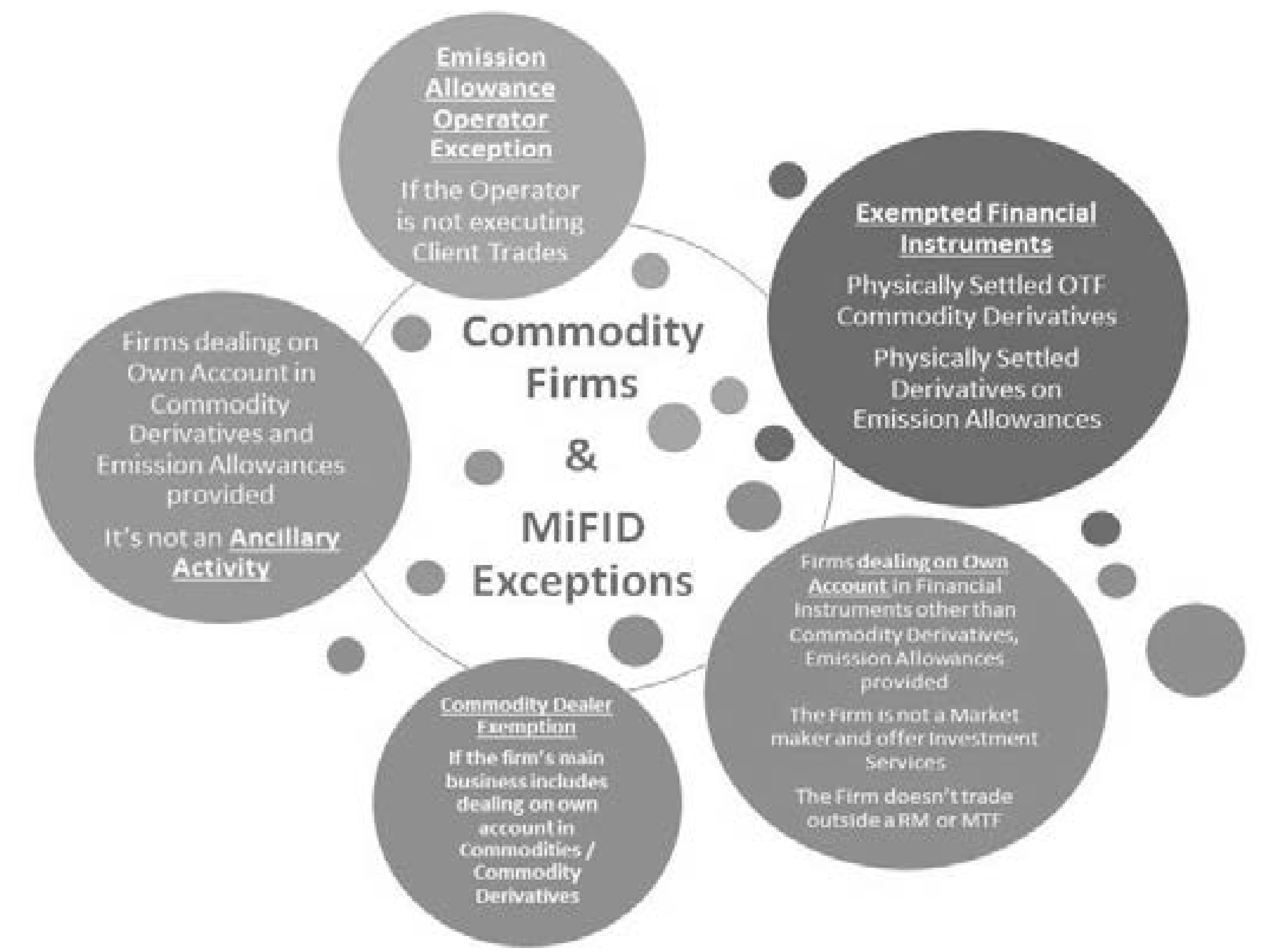

Figure 1: MiFID I Exemptions for Commodity Firms

In addition to the major exemptions, MiFID I has other minor provisions such as

- Emission Allowance operators are exempted provided they deal on their own account.
- Firms providing investment services to the main business are exempt
- Definition of Financial Instruments under MiFID I does not include Physically Settled Commodity Derivatives traded in an Organized Trading Facility (OTF).

MiFID II and Commodities / Energy Trading

As the Commodity market grew complex and the participants dealing in commodities increased, there has been an increased scrutiny on the transparency. MiFID I regulation's limitations has been addressed as part of MiFID II changes which includes widening of the reporting scope, narrowing down exemptions and introduction of position limits.

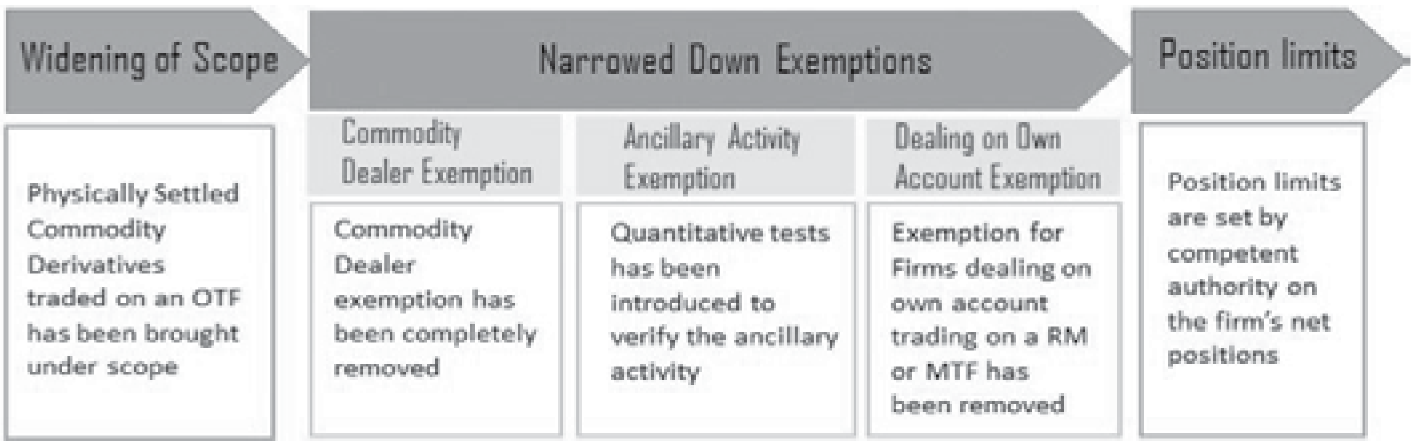

Figure 2: MiFID II Changes

Widening of Reporting Scope

MiFID II has widened the scope of reporting by including the below Instruments

- Physically settled commodity derivatives traded on an Organized Trading Facility (OTF).
- Definition of C6 commodity derivatives has been modified to include commodity derivatives traded on an OTF, except for wholesale physically settled energy contracts.
- Emission allowances.
- C6 energy derivatives which includes Physically Settled Oil and Coal Derivatives traded on an OTF.

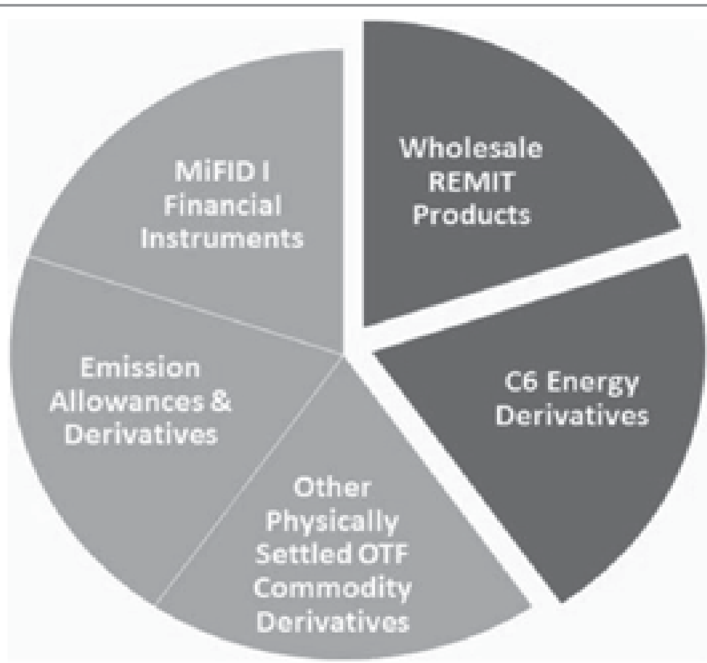

Figure 3: MiFID II Financial Instruments Scope

Narrowed down Exemptions

- Exemption provided for commodity dealers has been removed
- Proprietary trading exemption for commodities has been modified to remove exemption for firms trading on a RM or MTF.
- Quantitative tests have been included to the ancillary activity exemption.

"Market Share Threshold" Test

This test is used to determine if the Commodity firm is a large participant in a particular Commodity asset class. The firm's group level trading operations in a particular Commodity asset class is compared with the overall trading performed in the asset class by all participants within EU region. Thresholds are set for each Commodity asset class.

•4 %-Metal Derivatives	•4 %-Derivatives on agricultural products
•3 %-Oil Derivatives	•15 %-Freight and Commodity Derivatives
•20 %-Emmission Allowance	•3 %-Gas Derivatives
•6 %-Power Derivatives	•10 %-Coal Derivatives

Figure 4: Market Share threshold[3]

If the firm breaches any of the trading activity thresholds it needs to comply with MiFID II regulation.

"Main Business Threshold" Test

Main business threshold test does a comparison of the firm's trading activities excluding the transactions that are privileged such as intra-group and hedging transactions across Commodity asset classes against the group level trading activity which includes privileged transactions.

It's considered to be a minority activity if,

- The firm's activity is less that 10% of the group level trading activity.
- The firm's activity exceeds 10 % of the group level trading activity and the market share in each commodity asset class does not exceed 50% of the corresponding threshold.
- If the firm's activity exceeds 50 % of the group level trading activity and the market share in each commodity asset class does not exceed 20% of the corresponding threshold.

Market Share Threshold						Main Business Threshold		
Metals	Oil	Power	Gas	Coal	Emissions	< 10%	10 – 50 %	>50%
>4%	>3%	>6%	>3%	>10%	>20%			
>2%	>1.5%	>3%	>1.5%	>5%	>10%	NA		
>0.5%	>0.6%	>1.2%	>0.6%	>2%	>4%	NA	NA	
<0.5%	<0.6%	<1.2%	<0.6%	<2%	<4%	NA	NA	NA

Table 1: Combined MiFID II Thresholds[4]

Position Limits Regime

MiFID II position limits are applied by the region's competent authority on the firm's net positions and aggregated positions at a group level for all commodity asset classes traded on an EU venue and the economically equivalent Over the Counter (OTC) contracts.

Generic Position Limits

- Generic position limits are applied on commodity derivatives with similar characteristics which are traded in venues across member states in significant volumes.
- Commodity derivatives are considered to be "Similar" if they have similar contractual specifications excluding the post-trade risk management arrangements and form a single fungible pool of open interest.
- The trading volumes for a commodity derivative in a venue is considered to be significant if over a period of three months the open interest exceeds 10,000 lots.

Calculation Methodology for Specific limits

- The regime allows for Tiered approach for certain new/ illiquid contracts , where a position limit of 2500 lots is fixed and 10000 lots is set as DE MINIMIS limit which when exceeded will trigger the standard calculation methodology.
- Standard Calculation methodology considers a % of open interest for other month contracts and a % of commodities available for delivery for spot month as the limit.
- Quantitative Thresholds are adjusted based on the market condition to maintain liquidity. European Securities and Markets Authority (ESMA) has proposed the following threshold ranges
  * 25% of Deliverable supply for spot contract which can be increased up to 10% or decreased up to 20%
  * 25% of Open interest for other months contract which can be reduced to 5% or increased up to 35%
- Calculation of a firm's net positions in an instrument can be done by aggregating & netting off the positions held based on the 'similar' commodity derivative concept separately for other months' and spot month contracts.

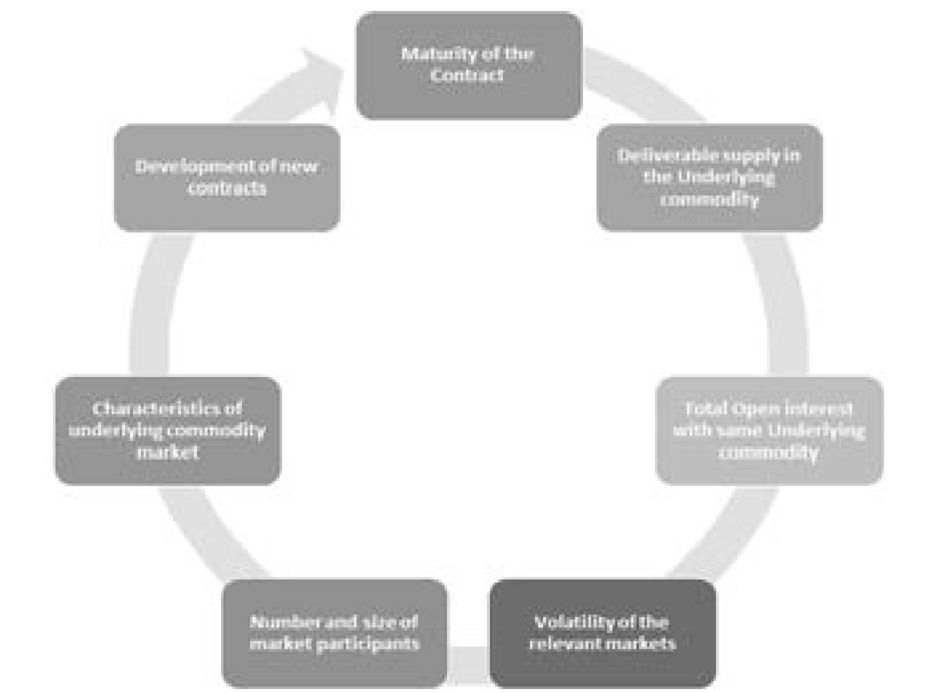

Figure 5: Contributing factors for position limits

Aggregating the positions at a Group level

The positions at each of the subsidiary firms are aggregated at a group level if the group directly owns the positions or if it can control the positions.

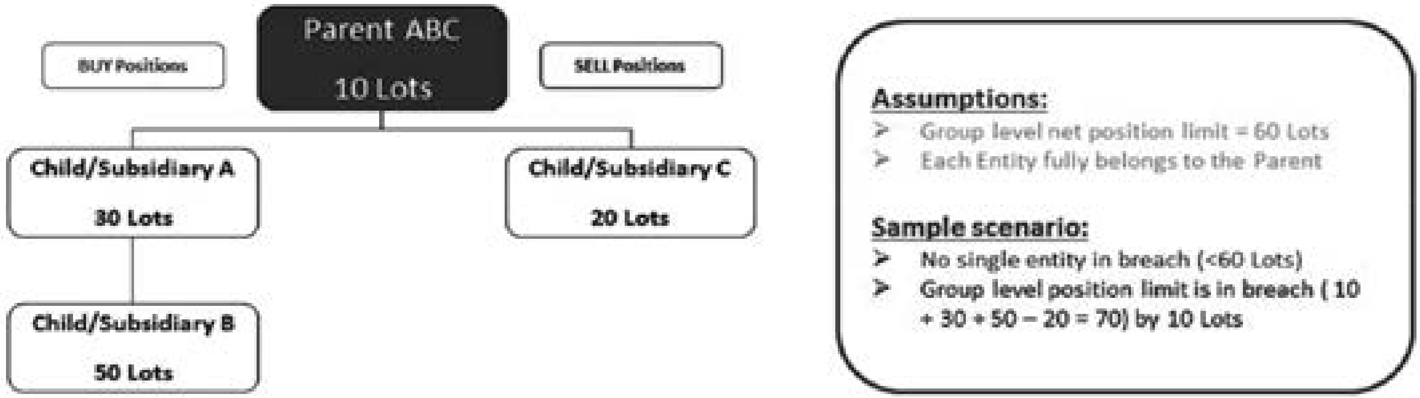

Figure 6: Aggregation at group level

MiFID II – Implementation Challenges for Commodity & Energy Trading Firms

Trading firms that were exempted under MiFID I need to start performing impact assessment based on the narrowed down exemptions and position limits requirements. Trading firms can range between Commodity trading houses, trading entities of Commodity / Energy producers and Utilities, Commodity Trading entities of big banks etc. Smaller regional players will have the biggest impact due to a lack of complex regulatory infrastructure and a legal entity structure.

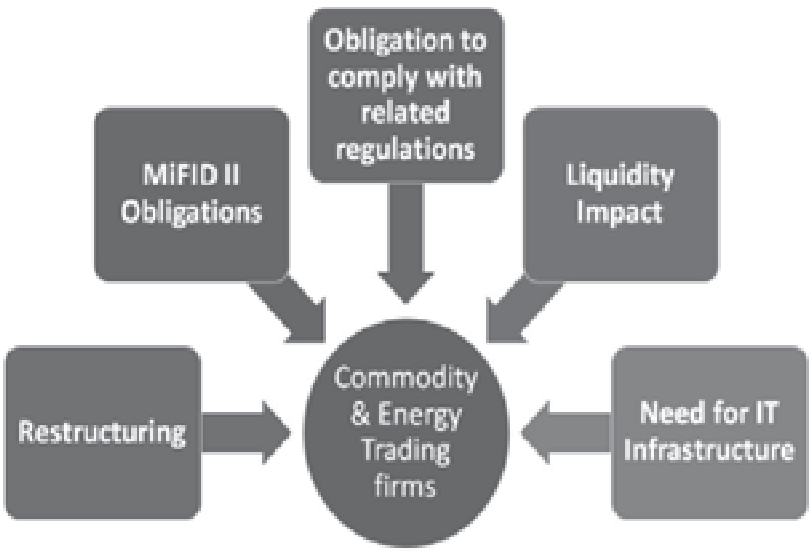

Figure 7: Implications for Commodity & Energy Trading Firms

Firms will face the below challenges

- Restructuring - Legal entity restructuring required to create a MiFID authorized entity and move the trading activities into the entity if the exemptions are not applicable.
- MiFID II Obligations - If the firm fails the ancillary activity test, MiFID II Authorization will be required and the firm has to comply with the other requirements such as Transparency, Transaction reporting and position reporting.
- Obligation to comply with related regulations - The flip side of requiring MiFID II authorization is that the firm will have to comply with the operating capital requirements under CRD IV and the firm will be classified as a Financial Counter party under EMIR which has a clearing obligation associated.
- Liquidity Impact - Position limits regime and the Market share thresholds might impact liquidity and the market structure for some of the commodity asset classes
- Need for IT Infrastructure
  * Changes to IT systems required to enable trading desks to segregate the hedging transactions from speculative transactions.
  * In case of exempted firms, IT Infrastructure required to compute the Ancillary activity test results and report annually to the regulator which forms the evidence for the exemptions.
  * IT Infrastructure required to monitor the positions based on the position limits set as per the regulation.

Conclusion

The 2008 financial crisis laid bare the flaws of MiFID I as a regulation which led to its review later on. MiFID II with its wide ranging changes broadened the scope of reporting with a renewed focus on commodity and energy trading. The Commodity and Energy firms will have to start assessing their MiFID II compliance status and analyze the IT and Operational changes required to comply. MiFID II changes will bring in increased transparency and efficiency but on the flipside, IT spending of the firms is set to go up and thus might impact the cost of trading and liquidity in the market. Smaller players will have a bigger impact when compared to the big banks and commodity producers.

Key References

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2. Will Acworth, March 2016 - Market Voice Magazine : Annual Survey Global Derivatives Volume http://marketvoicemag.org/?q=content/2015-annual-survey-global-derivatives-volume#top
   Note: MTF: Multi-Lateral Trading Facility; RM: Regulated Markets
3. ESMA , May 2016 - Amended draft RTS 20 on criteria to establish ancillary activity , Brussels, ESMA Publication
   Note : REMIT : Regulation on Wholesale Energy Market Integrity and Transparency
4. Siobhan Hall, June 2015 - ESMA to rethink EU Mifid ii thresholds , London , Platts Publication http://www.platts.com/latest-news/electric-power/brussels/esma-to-rethink-eu-mifid-ii-financial-thresholds-21630883
   Note: EU : European Union

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