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Regulatory reform of EU commodity derivatives markets

5th meeting of the Expert Group on agricultural commodity derivatives and spot markets

Brussels, 14 February, 2014

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The MiFID review: main objectives

- Updates required in light of developments in market structures and technology to ensure fair competition and efficient markets
- Tackle loopholes and less regulated and more opaque parts of the financial system in line with G20 consensus
- Improve oversight and transparency of commodity derivative markets to ensure their function for hedging and price discovery
- Raise investor protection in specific areas to support confidence
- Increased supervisory convergence across the single market and harmonised third country regime

State of play

- Comprehensive package ("MIFID II"):
  - **Markets in Financial Instruments Directive (MiFID)**
  - **Markets in Financial Instruments Regulation (MiFIR)**
  - **Market Abuse Regulation (MAR)**
  - **Criminal Sanctions on Market Abuse Directive (CSMAD)**
- Timing:
  - **Political agreement on MAR endorsed by EP on 10 September 2013**
  - **Political agreement on CSMAD on 10 December 2013, endorsed by the EP vote on 4 February**
  - **Political agreement on MIFID/R on 14 January 2014, EP endorsement scheduled for April 2014**
  - **Entry into application**
    - MAR & CSMAD - 24 months (mid 2016)
    - MiFID/R - 30 months (end 2016)

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MIFID/R

Overview of final outcome of negotiations

Derivatives

- Mandate trading of OTC derivatives on multilateral and transparent trading venues - G20 commitments - complement to EMIR

  - **Trading/clearing obligation derivatives**
    - Only eligible trading venues: Regulated markets, MTF, OTF or third country venue (declared equivalent)
    - Sufficient liquidity
    - Determination by ESMA (RTS)
    - Trading venue must ensure that all exchange traded derivatives are cleared

  - **Introduction of Organised Trading Facility (OTF), a neutral platform**
    - Strict rules on discretion
    - Ban on proprietary trade
    - Restriction on matched principal trading (MPT)
      - Banned for derivatives subject to clearing obligation
      - For other derivatives MPT allowed only when client consents

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Derivatives II

- General pre- and post-trade transparency obligation
- Enhance price formation, reduce information asymmetries and promote competition
- Pre-trade transparency obligation
  - **Calibration by trading system**
  - **Waivers can be granted by NCA for**
    - Large in scale
    - RFQ/voice trading above size specific to instrument, where undue liquidity risk (distinction retail/wholesale)
    - Derivatives not subject to the trading obligation + "other" illiquid instruments
  - **Hedging trades by NFC excluded**

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Derivatives III

- Calibration of post-trade transparency requirements:
  - **Delayed disclosure for LIS, illiquid instruments, transactions above size specific to instrument (dynamic calibration)**
  - **Additional disclosure exemption available: aggregation (during and after deferral period), volume masking**
- ESMA to provide detail in Level2
- Commission position: regret not more ambitious regime, but an important step in the right direction towards greater transparency in this area.

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Commodity derivatives

Key areas of discussion among co-legislators

- Delineation between financial & physical markets
- Exemptions: capture non-financial entities acting as financial entities
- Position limits/management: market integrity and orderly pricing

Delineation with physical markets

- Financial instruments " tests"
    - **Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;**
    - **Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products as defined in Article 2 paragraph 4 of Regulation (EU) No 1227/2011 traded on an OTF that must be physically settled;**
    - **Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments;**
- Level 2 legislation provided for to specify elements of definitions

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Exemptions

- Exemption from MIFID applies to
  - Persons who **deal on own account** including market making in commodity derivatives (including emission allowances/derivatives) **excluding** persons who deal on account by executing client orders **OR**
  - Persons **providing investment services**, other than dealing on own account, in commodity derivatives (including emission allowances/derivatives) to the customers or suppliers of their main business;
  - provided that for each of the above cases individually and on an aggregate basis this is an **ancillary activity** to their main business when considered on a group basis, and:
    - that main business is not the provision of investment services or banking services, or acting as a market-maker in relation to commodity derivatives
    - the persons do not apply a high frequency algorithmic trading technique

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Exemptions II

- Level2 to further specify ancillarity

  - **At least the following criteria should be considered:**
    - Activity must be minority activity at group level
    - The relative size of the trading activity compared to overall market trading activity in the asset class

  - **Excluded from assessment:**
    - Intragroup transactions
    - Hedging
    - Fullfilment of liquidity obligations under EU or national law, regulation, or trading venue rules

Posititition limits /management/reporting

- Main features:
  - **A EU harmonised regime: NCAs to set net position limits that any person can hold in commodity derivatives at all times based on methodology set by ESMA**
  - **Position-reporting obligation by category of trader**
  - **Additional safeguards through position management controls by trading venues**

- Objectives of position limits
  - **Prevent market abuse (MAD)**
  - **Support orderly pricing and settlement conditions, including preventing market distorting positions**

Posititition limits

- Contracts within scope :
  - **All exchange traded commodity derivatives**
  - **Economically equivalent OTC contracts**

- Hedging exemption:
  - **Positions held by a non-financial companies objectively measurable as reducing risks directly related to their commercial activity.**

- Limits set
  - **By contract**
  - **At a net-basis**

- Limits imposed on "persons"
  - **Ultimate client concerned**
  - **Positions are aggregated at group level**

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Posititition management

- Trading venues must have management controls in place:
  - **Monitor open positions**
  - **Access information**
  - **Require reduction or termination (temporary or permanent)**
  - **Request provision of liquidity back into market**

- No further harmonisation in L1 or L2 but notification requirement

Positition reporting

- For exchange traded derivatives, trading venues to Publically report weekly (aggregation) by categories of persons
- For both exchange traded derivatives and OTC a complete break-down of positions held by all persons to NCAS at least daily
- Members, participants (RM, MTF) and clients (OTF) to report to the trading venues their own and end-client's position at least daily

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Overview role of NCAs & ESMA

- Role of NCAs
  - **Sets limit based on ESMA methodology - when significant trading on more than one jurisdiction: one "central authority" sets limit**
  - **Supervision of compliance with position limits**
  - **Intervention powers (e.g. reduction, termination)**
  - **Sanctioning powers for violations**

- Role of ESMA
  - **Sets methodology & monitors implementation by NCAs**
  - **Coordination of national position management measures**
  - **Dispute settlement powers in case of disagreement between NCAs**
  - **Residual powers to intervene in case of threat to the orderly functionning and integrity of financial markets & failure to act by NCAs (all derivatives)**

Trading controls

- Main features/Objective
  - **Following pace with technological development (high frequency trading/algorithmic trading)**
  - **Ensuring safe and orderly markets / financial stability (prevent flash crashes).**
  - **Restrictions in trading conduct, safeguards & controls, reporting requirements, compliance monitoring, intervention measures, and enhanced cooperation between national competent authorities**

- Main responsibility with investment firm
  - **When engaging in algorithmic trading: obligation to have in place effective systems and risk controls**
  - **When providing direct electronic access: obligation to have effective systems and controls in place for their clients**
  - **When engaging in algorithmic trading to pursue a market making strategy: obligation to provide liquidity on a continous basis**

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Trading controls II

- Trading venues have overall responsibility to ensure that trading systems deliver orderly trading and for this purpose must:
  - **Have in place effective systems, procedures and arrangements to ensure resilience and that sufficient capacity is available**
  - **Enter into written agreements with firms providing market making strategy detailling liquidity obligation**
  - **Have circuit breakers in place to halt or constrain trading**
  - **Ensure that fee structures do not create incentives to place, modify or cancel orders or to execute transactions in a way which contributes to disorderly trading conditions**
  - **Have in place harmonised minimum tick-sizes (currently not applicable to derivatives, can be extended in Level2 when necessary for orderly trading)**
  - **Synchronise business clocks**

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Benchmarks

- **Proposal adopted on 18 September 2013:**
- **EP report vote 15 April**
- **Council working group starting end February**
- **Objective to reach agreement by end 2014**

Thank you for your attention