



**OPEC EU Regulatory Update - A View from the Venues**  
IEA-IEF-OPEC Workshop; 15 March 2016

## **Regulatory Developments Affecting the Energy Markets and Implications for Oil Markets**

- *Context: How did we get here, lessons learned so far*
- *Scope of Market Regulation*
  - *Participants and Instruments Covered*
  - *Hedges versus Trees*
- *Measurement of Positions verses Risk*
  - *Position Limits*
  - *Commitment of Traders Reporting*
  - *Comparisons to developments in Dodd-Frank*
- *Traded Oil Markets*
  - *Consequences and Implications*

***Alexander McDonald, Chief Executive Officer***  
***Wholesale Markets Brokers' Association & London Energy Brokers' Association***

Context: How did we get here, Lessons learned so far



- Thanks to:
  - BP
  - CME
  - ICE Futures Europe
  - Total
  
- Many further thoughts at Oxford Institute for Energy Studies Forum - **Energy Trading at the Crossroads**; December 2015
  - <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/02/OEF-103.pdf>
  - *MiFID II: the impact on commodity markets from a venue perspective*
    - Ben Pott and Graham Francis of ICAP
  - *Regulatory change: impact on major energy companies and challenges they face*
    - Jonathan Hill of BP

Context: How did we get here, Lessons learned so far



## Why? - What is the Point of Regulation?

- Financial Regulation has its origins in *Capital and Liquidity*
  - Leverage and Supervision (Authorisation)
  - Read across to commodities – collateral assets
  - “Massive Passives” - Gary Gensler, Bart Chiltern, Michael Barnier
  - Position Limits & Position Reporting
- Systemic Risk
  - Physical Commodities <-> Forward Contracts/ Derivatives
  - Price – Trade Information (Delivery Limits and Squeezes)
  - Volumes – Position Reporting
- The Consumer
  - Wholesale versus Retail
  - Regional versus Global
- Conduct
  - Market Rules / Market Abuse
  - Transaction Reports
- Tax and Protect
  - Tariffs / GATT / TTIP / FTT

Context: How did we get here, Lessons learned so far

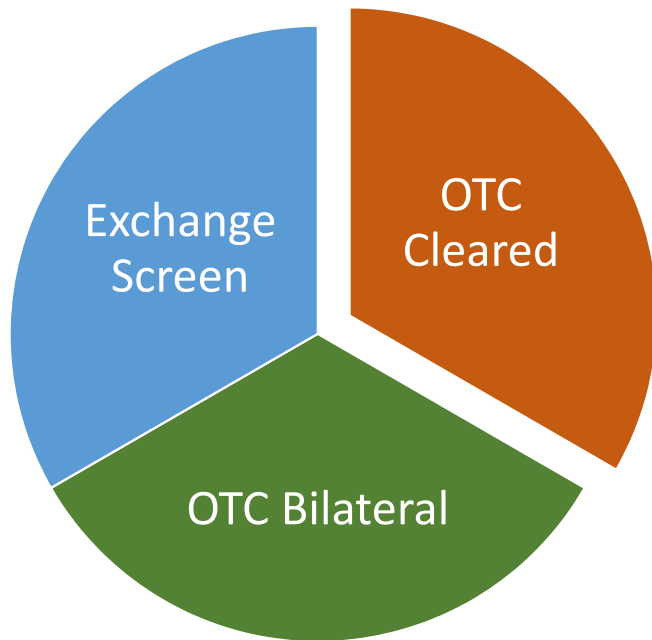


## Waypoints and Lessons

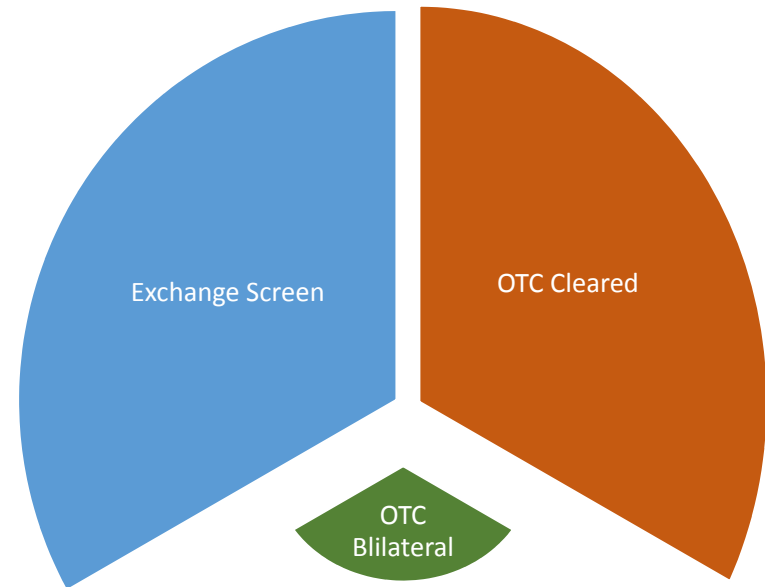
- The Problem of Defining the Problem:
  - *Scope, Price, Quantity, Fairness, Access, Transparency, Other...*
- Role of Nodes or Bridges
  - Vertical Siloed Exchanges
    - Rulebooks & Membership
    - Contracts, Specifications & Delivery
  - The Real World
    - Geography, Basis Risk
    - Cash Settlement and Physical Settlement
    - Standardisation Solutions: Common Credit Masters, TrayPort, Contract Fungibility
  - Position Limits & Position Reporting
    - CFTC and FERC - Energy and Environmental Markets Advisory Committee (EEMAC)
- Who Regulates?
  - DG FISMA and DG Energy / Ministries of Finance & Energy / ESMA and ACER / NCAs
  - IEA & OPEC or CPMI & IOSCO

# Brokered Oil Markets: Changes Over Last 5 years

From:



To:



Context: How did we get here, Lessons learned so far



## For Instance, Even Yesterday...

***Now You See It, Now You Don't*** – CFTC EEMAC Withdraws Report Regarding Proposed Position Limits: The February 25, 2016 report issued by the Commodity Futures Trading Commissions' Energy and Environmental Markets Advisory Committee, saying there was no evidence justifying proposed CFTC position limits, was withdrawn last week. In a statement issued by Commissioner J. Christopher Giancarlo, sponsor of EEMAC, "[t]he report was never intended to be a distraction from the substantive policy work of the Committee and the volunteer members who give their time and expertise." No other explanation was provided for the withdrawal.

**Conclusion and Recommendations:** It is the considered view of the Energy and Environmental Markets Advisory Committee that the CFTC should not finalize the position limits rule, as proposed.

Clearly given that the MIFID Position Limit and COT rules in the proposed RTS are under review, these developments in the US regime, from which EU\_COMM borrowed line for line, are interesting

- The problem is there isn't enough speculation in oil, not that there is too much, industry tells the CFTC
- The Proposed Rule Fails the Decades-Old Necessity Finding Required by the Commodity Exchange Act
- The Proposed Rule for Position Limits Poses a Serious Threat to Energy Market Liquidity
- The Enumerated Hedges in the 2013 Proposed Rule are Excessively Narrow
- An Expanded Accountability Regime is a More Workable Alternative to Single and All-Month Limits
- new position limits are likely to have the serious unintended consequence of further reducing liquidity in energy derivatives, especially for those with delivery dates beyond the first several months (i.e., "further out on the curve"). This reduced liquidity would harm hedgers, who are already having trouble accessing liquidity, particularly in smaller, more regional power and gas markets
- The CFTC's proposed enumerated hedges exclude many commonly utilized risk management strategies. Thus, limiting bona fide hedging to the proposed enumerated hedges would have the unintended, and highly deleterious, effect of unnecessarily constraining effective energy hedging strategies
- Exchanges should play a central role in the process of evaluating and granting hedging exemptions for non-enumerated hedges
- ***In the words of one participant, the Proposed Rule is "a solution to a non-existent problem"***

Members Voting to Approve: James Allison Michael Cosgrove Bryan Durkin Benjamin Jackson William McCoy Craig Pirrong Lopa Parikh Dena Wiggins <sup>6</sup>

Members Voting to Dissent: Tyson Slocum; see separate written dissent.

## Waypoints and Lessons 2

- CFTC migrated the commodities markets from swaps to futures in Q3 2012
- Inter-Dealer brokers are only arranging what is now listed RM products under the relevant exchange rules.
- The exchanges converted the clearable swaps post-Dodd Frank into Swap Futures meaning an IDB doing this business would not be subject to OTF rules but that of the exchange (Block thresholds/Transparency/time limits etc).
- 1 day VAR v 5 day VAR (liquidation)
- Utterly dependant on the Block Trade Limits set under the rules of the RM. These are far smaller than the Block Trade limits on SEFs set by the CFTC
- CCP recognition / deference between US & EU for MPoR was a deal breaker for the RMs
- *If the position limits regime is extended to what are RM products then ICE & CME will just dual list its benchmark contracts outside the EU. Proof is already there with ICE listing Brent Futures mini-contract in Singapore.*
- *Worth looking at Dodd-Frank Core Principle 9 & how the CFTC has kicked it into the long grass because it knows once it mandates block thresholds on the US DCMs, the exchange will offer that product outside the US. (CME prepared for it by listing contracts on CME Europe).*

## Commodities under MiFID2

- Based in a general principal of inclusion under a wide scope
- Narrower and targeted exemptions
- Some issues:
  - Proportionality and appropriateness
  - Definitions of commodities and of commodity derivatives
    - *Who, What, Where and Why? (upside down legislation)*
  - Different overlapping and orthogonal legislations (*EMIR, REMIT, CRR, BENCH, SFTR*)
  - Commitment of Trader Reporting
    - *EU Call for Evidence – NCA views*
  - Ancillary Activities Exemptions
    - *Bringing back the exemption test considering the ratio of the capital employed for carrying out the ancillary activity to the capital employed for carrying out the main business.*
    - Challenges for top-down (data capture) and for bottom-up (intent) regulation



## Expanded Scope under MiFID II

- Under MiFID I, many firms trading commodity derivatives are able to rely on exemptions to avoid the need for authorisation. MiFID II will severely restrict those exemptions.
- MiFID II still provides an exemption from its scope for firms dealing in commodity derivatives on their own account, provided that this activity is ancillary to their main business. ESMA has been mandated to determine via RTS when activity is to be considered as ancillary.
- While there are therefore still some moving pieces, what can be expected is that the final rules will be consistent with the broader MiFID II policy objective of bringing more commodity trading firms within the scope of European financial regulation.
- The consequences of **NFC firms being brought within the scope of MiFID II are important** – because once a firm falls within scope it becomes subject to the requirements of a MiFID authorised firm, the EU capital requirements framework, being a financial counterparty under EMIR and application of the full MiFID II position limits regime.
- Introduction of capital requirements for commodity trading firms could be a single biggest challenge for the industry. If inappropriately calibrated, it is estimated that capital requirements could add between EUR 50 and 500 million in compliance and risk management costs for each commodity dealer.
- Basel III regulations contain a **leverage ratio formulation** that counts segregated customer margin as leverage in calculating a bank's capital requirements. The futures industry has demonstrated to regulators that customer margin is highly regulated and segregated away from a bank's assets and should be recognized as exposure-reducing in the Basel calculations. Without such an offset, banks will face an increase in the amount of capital required to support futures clearing which will directly impact on the ability for banks to offer client clearing services to commodities market participants.
- Higher marginal costs to commodity dealers will have an impact on commodities trading activity with consequent and dramatic reduction in market liquidity and quality. The costs of requirements would be passed by those remaining to other market participants and ultimately to consumers.

## Commodities under MiFID2: Hedges versus Trees

- Industry up in arms over position limits: it believes that position management (*i.e. the use and intent of a given position rather than its size alone*) as opposed to fixed position limits per se is a superior approach for efficient and well-functioning markets.
- Level I of MIFID II - hedge exemptions can only be relied upon by non-financial entities.
- In parallel, MiFID II is set to require a significant number of utilities and large commercial hedgers to register as MIFID firms - effectively excluding such firms from hedge exemptions and introducing the other attendant controls and regulatory costs
- Key to a successful implementation of appropriate levels for such limits is the recognition of the co-dependency of commercial and non-commercial (*'speculative' or financial*) segments of markets.
- For effective risk transfer to take place between commercial to non-commercial entities and hence bona fide hedging to take place, the ability of financial players to take the other side of large commercial positions governs the sustainability and viability of commercial hedging in turn.
- The alternative is a failed market or reduced liquidity, especially at times of stress when commercials would be less likely to be the default offerors of liquidity relative to non-commercial entities.
- **If there is no potential reward for assuming risk or regulatory strictures become too extreme, risk transfer will not take place.**

## Making the MIFID II Position Limit Regime Work

- The current definition of the Spot Month means that a 'spot month' limit will apply for the entirety of the period for which a contract is the front month. This will have a material adverse impact on front month liquidity in key benchmark contracts unduly constraining market activity and will encourage regulatory arbitrage.
  - The MiFID II RTS definition of 'spot month' should be amended to align the application of spot month limits with current international practices, allowing larger positions to be held and unwound in an orderly manner in the run-up to the commencement of the spot month period and avoiding regulatory arbitrage.
- Basing other month position limits on open interest rather than deliverable supply is likely to have an adverse impact on new or illiquid contracts where there are a small number of participants and open interest is typically low relative to deliverable supply.
  - While the RTS recognises an issue with 'new and illiquid' contracts, this is limited to contracts with open interest below 10,000 lots. This is insufficient in cases such as those described above, where the application of other month limits based on open interest will adversely impact the ability of these participants to hedge their immediate price risk.
  - The RTS could provide additional flexibility to apply a deliverable supply based position limit up to a defined threshold (*with 'Benchmark contracts' above the threshold retaining an OI based position limit*) where it is deemed appropriate to do so.
- It is not yet clear what the final outcome on other/all month limits will be in the US but of course the US already applies a more proportionate regime for hedge exemptions, which have included paper to paper hedges for some banks.

## Unintended Consequences

Continuing down the current regulatory path of MiFID II RTS without amendment risks the following:

- **closing down commercial hedging**, exposing physical based entities to the full effect of inevitable spot physical volatility (the avoidance of which led to the creation of such derivative markets in the first place);
- **actually creating and increasing market fragmentation** by upsetting the balance between financial and non-financial, entities across a given market as a whole, or in certain market horizons, for example beyond just the closest few months of a strip of derivative futures contracts; and
- **increasing basis risks** by making very specific former 'swap' markets unworkable due to the withdrawal of non-commercials or 'speculative' trading interests from them in their entirety (especially for 'other' month limits).

## Ongoing Review

- In the UK, the Government's ***Fair and Effective Markets Review*** released its final report earlier this summer, which contains several high-level recommendations to increase transparency, integrity and accountability within the commodities markets.
- Many participants praised Power and Gas market structure, together with bespoke regulation
- The report does not provide precise details regarding when and how the UK authorities will introduce new rules into the commodities markets, but it appears likely that participants in these markets will be under additional scrutiny going forward, and new rulemaking efforts could be on the horizon.
- For instance, with specific reference to the Fair and Effective Markets Review, the FCA recently released the results of a survey of commodity market participants, which looked at the compliance and market abuse functions deployed by smaller, non-bank commodity trading firms.
- EU Call for Evidence on Markets Regulation provided much feedback in Commodity space, not least from NCAs in Europe

## Further Regulations: Product and Scope

- *European legislators have recently finished negotiating a regulation that will provide rules for setting benchmarks in the EU. The scope of proposed regulation is extremely broad; it covers both financial benchmarks and commodity price assessments.*
- **Key issues:**
  - *Appropriateness and Scope*
  - *Cross Border*
  - *Proportionality*
  - *Choice and Competition*
  - *Cost and Access*
  - *Interaction with Regulations and Conduct*

## Further Regulations: Product and Scope

- Commodity benchmarks are particularly sensitive to any chilling effect that over-prescriptive regulation may have on submitters.
- In markets where transaction data are by nature too sparse to support regularly published, submission-based indexes, benchmarks have emerged that are based on surveys and price reporting functions.
- Robustness, reliability, and representativeness of such benchmarks rely on voluntary contributions of both transactional and non-transactional data.
- To ensure that such benchmarks remain reflective of market conditions, the broadest possible participation of data contributors should be encouraged.
- The issue of the widespread activity of PRAs in commodity benchmarks:
  - PRA Journalism – Prices paid
  - Quantity Information
  - Mark-to-market
  - Contract Settlement Prices
- To this end it is important that the regulation will not create unnecessary disincentives for market participants to take part in this price-formation process, results of which are so crucial for properly functioning commodity markets.
- Legislation needs to be appropriately tailored to reflect the unique characteristics of such markets.
- Simple application of financial services regulation in such sensitive area would be counterproductive.

## **Traded Oil Markets: Consequences and Implications**

- Truly Global
- Physical v Derivative
- Great Change: Technology, Geopolitics, Engineering
- Dominated by NFCs: 'Insiders' who are one way around
- Multitude of Products, Paucity of Transactions
- Largely Cleared
- Regulatory Environment:
  - Trade versus Post-Trade
  - Market Segments - Benchmarks
  - Systemic Requirements?
  - Conduct Requirements?
  - Reporting Requirements?
  - Pricing and Quantity Requirements? (OPEC, SOR)



## **Brokered Oil Markets**

### Spreads, Swaps and Packages

- North Sea Brent, Urals, Dubai, MOPs, Options (Brent, WTI), MoGas, Gasoline, Naphtha, LPG, Gas Oil, Fuel Oil, Sing Gas Oil, Gas Oil/Feedstock Physical.

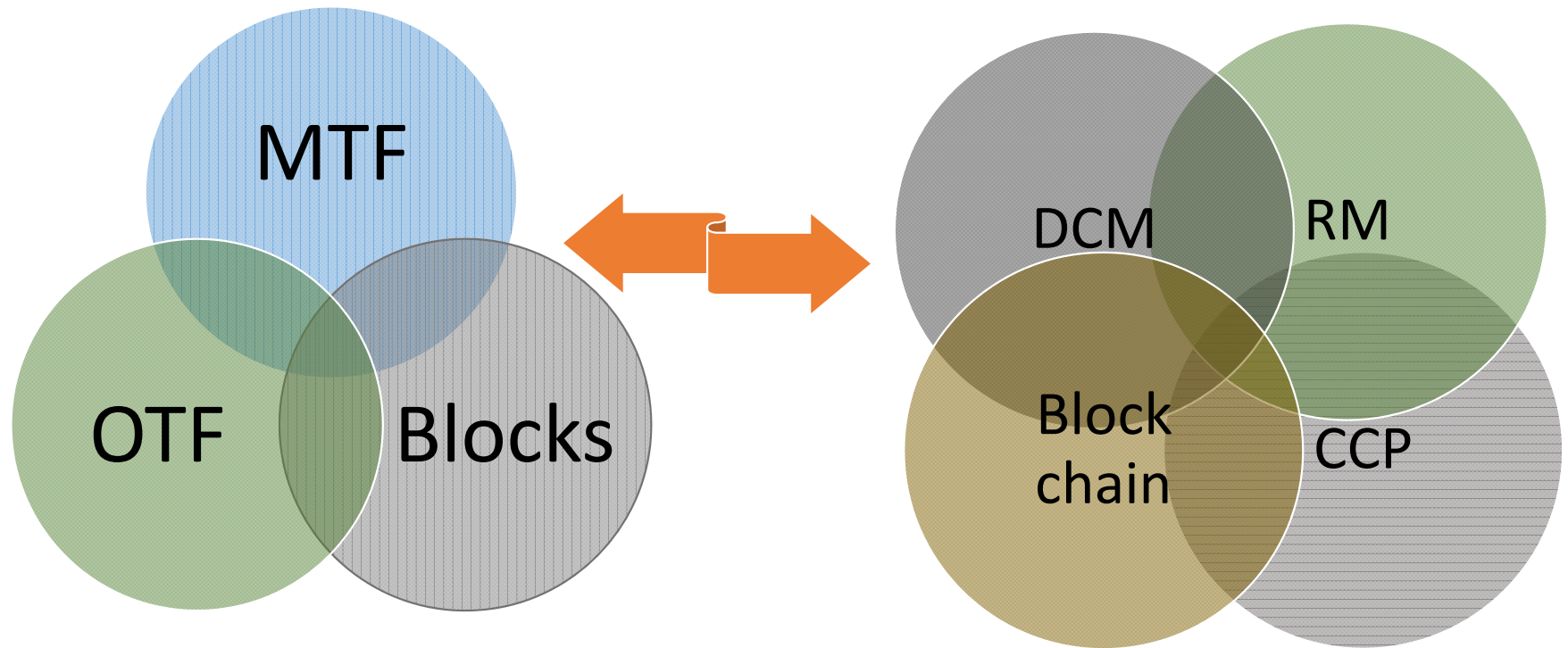
### Spreads to Futures

- Brent Futures, Gasoil, Coal, Coal Options, Emissions and Biomass.

### The BFOE Window

- ICE\_Platts Window and Dated Brent CfDs

## Brokered Oil Markets



## **Annex Slides**

# **Details on EU Regulation Issues on Energy Commodity Markets**

# MiFID2/R & Commodities: Key Items

*Shakespearian Comic Relief in Act 3*

- Expansion of Product Scope
- Position Limits
- Position Reporting
- Ancillary Business Exemption
- Crossover into REMIT, EMIR, CRD4/CRR, MAD2/MAR, SFTR, Dodd Frank (CEA)
- Transparency & Systematic Internalisers

## New Commodity Position Limits

- An entirely new concept at NCA level, an American import with the task of addressing EU Political aspirations
- Plenty of opacity
- Limits to be set and enforced for all commodity derivatives on all EU trading venues (Regulated Market, MTF or OTF)
- The factors used to set limits are set out at Level 1, and the methodology to apply them is set out at Level 2
- A *de-minimis* regime is proposed for new and illiquid contracts to avoid damaging liquidity and innovative commercial activity
- Regulators set and enforce limits – new work for them and is a considerable burden as the range of contracts is considerable
- Hedging transactions excluded but only where held by non-financial entity

## “Commodity derivatives on trading venues”

- “...position limits on the size of a net position which a person can hold at all times in commodity derivatives traded on trading venues and economically equivalent OTC contracts...” MiFID2, art 57(1)
- “Trading venues”: RMs, MTFs or OTFs
- “Commodity Derivatives” include:
  - Many physical forwards (subject to “REMIT” C6/C7 carve-out)
  - Derivatives on “exotics” (freight, emissions etc.)
  - Securitised derivatives (certificate & warrant programs)
- So PLs do not apply to:
  - Non-EEA venues
  - Spot physical
  - REMIT products carved out of C6/C7
  - ETCs/ETNs?
- Single position limit per contract per TV - Potentially 1000s of separate limits
  - Definition of “same” - Very narrow (“subset of economically equivalent”)
  - Cash-settled and physical futures are **not** “the same”

- For non-financial entities, positions hedging commercial activities may be exempted from limits.
- No such exemption, either proprietary or “pass-through” is available to regulated firms.
- Includes “Economically Equivalent OTC Contracts”
  - “EEOTC” is determined by the persons entering into the OTC and appropriate classification will be checked by NCA supervision
  - A list of EEOTC contracts will not be published
  - Excludes commercial physical holdings
  - Identical contract specifications, terms and conditions
- Netting: two buckets for “*Spot*” and for “*Other Months*” which covers all expiries other than the Spot Month
- Grossing up: of all long and short positions, including ETDs, “Same” contracts and EEOTCs within subsidiaries
- Group Aggregation of subsidiaries by including netting
  - Applied at an entity level and, on an aggregate basis, at a group level (top hold-co)

## Position Reporting (“CoT Reports”)

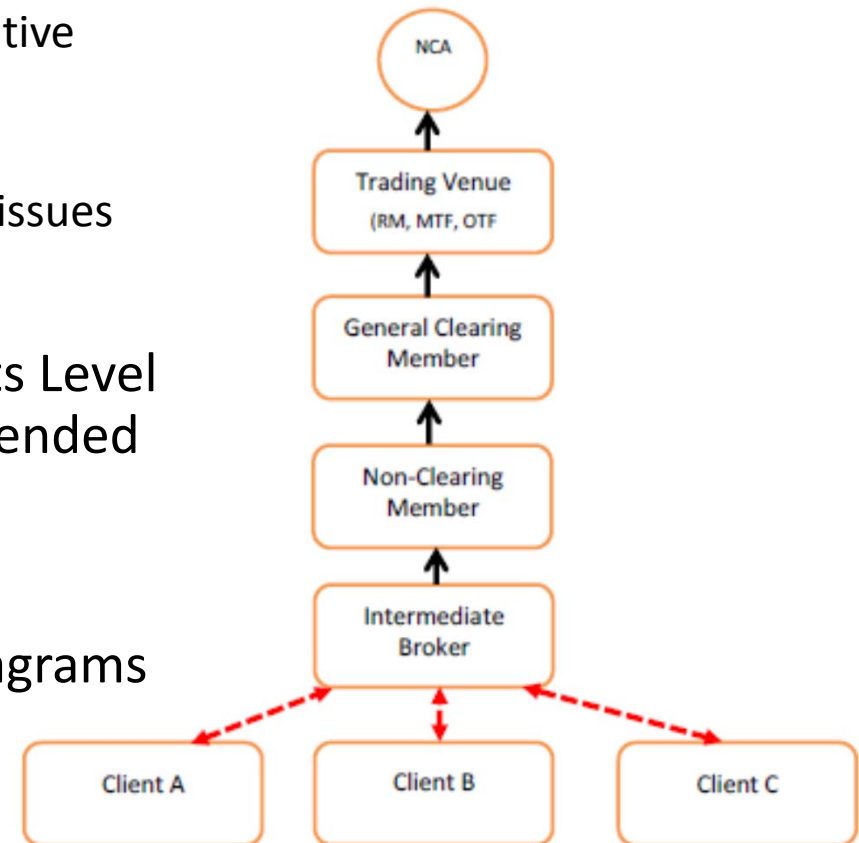
- The Level 1 requirements for reporting by trading venues and investment firms are extremely specific.
- Challenges all over the shop: operational, geographic and data privacy
- Reporting is done by ‘*members or participants*’ to trading venues of their proprietary positions, and those of their clients all the way down to the end client
- Reports must identify (amongst other items):
  - the position holder
  - the ultimate parent entity
  - identify each position as hedging or speculative



## Position Reporting (“CoT Reports”)



- ESMA is only mandated to define the report template for the OTC reporting by investment firms
  - Not the template for the Exchange Traded Derivative reports from Trading Venues
  - Not the mechanism by which data will flow
  - Not how to resolve EU and third country privacy issues
- ESMA will attempt to clarify these issues in its Level 3 work whilst still delivering the outcome intended by the co-legislators
- Currently a copy/paste from US Exchange diagrams
- Scope therefore limited to PERG Derivatives



## Scoping of Participants and Markets

- ‘Who’ and ‘What’ and ‘Where’ are all far from clear, nor settled
- The Commodities Regulatory Technical Standards will be subject to Comment letters back to ESMA from both legislating bodies and from the EU Commission.
- Expect some RTS revisions from Nov 2015
- Less likely to be changes to the Dec 2015 Technical Standards
- General progressive conferral of supervisions and rules towards Energy Regulators and Supervisors
- General financialisation of non-energy commodities markets
- Ancillary activity test: Difficult
  - *Political intent to extend the scope of financial regulation*
  - *One of the most contentious parts of MiFID*
  - *It is clear that no licensing required if no speculative activity*

## Who

- Market Counterparties v Investment Firms
    - Consequences of failure: *CRD IV capital requirements / become a financial counterparty under EMIR / hedging exemption re position limits lost*
  - MiFID Venues (*RM, MTF, OTF*) v Remit Venues (*Organised Market Places*)
- 
- Article 2(1)(j) covers:
    - dealing on own account in commodity derivatives (except when executing customer orders)
    - providing other investment services in commodity derivatives to customers or suppliers of their main business
  - But only if:
    - individually and on an aggregate basis this is ancillary activity to their main non-investment business when considered on a group basis
    - the person does not apply high frequency algorithmic trading techniques
    - an annual notification is made to the relevant regulator

## Who: The ‘Person’

### Territorial scope

- Intention to catch any “person” anywhere,
- However:
  - *“This Directive shall apply to investment firms, ...and third country firms providing investment services or performing investment activities through the establishment of a branch in the Union” (Art 1(1))*
  - *“[Position limits and position reporting] shall also apply to persons exempt under Article 2”(Art 1(6))*
- Discretion delegated down to NCA implementation.

---

### Intermediaries/customers

- Positions held by intermediary on behalf of a customer do not count towards that intermediary’s own position limits (even if held as principal)


## **Ancillary Activities**

- The specific intention from co-legislators is to extend the scope of financial regulation
- Firms that can demonstrate that they are not trading for speculative purposes will not require authorisation under MIFID2
- The tests are two-way:
  1. size of market share in a commodity class, and
  2. size of speculative vs. hedging trading activity
- Thresholds are set by ESMA based on CBA data and are different for each asset class
- Firms must pass both tests in order to be exempt MIFID2
- Allowances for trades undertaken for hedging purposes, for intra-group transactions, and for certain liquidity providers
- The draft RTS submitted by ESMA permits:
  - Portfolio hedging
  - Proxy hedging
  - Anticipatory hedging

## Ancillary Activities

### Ancillary Business Exemption

- “Trading Activity” test (by asset class):
  - $\left[ \frac{\text{Size of Trading Activity (in EU market)}}{\text{Overall market size (in EU market)}} \right]$
- “Main Business” test (all asset classes):
  - $\left[ \frac{\text{Relevant Trading Activity (Global)}}{\text{Total Size of Trading in (Global)}} \right]$
- **Key Concepts**
  - Trading activity: CDs, EAs and EADs
  - Privileged Transactions: “*risk-reducing trades*”; *intra-group trades* which are exempt from EMIR; and *compulsory liquidity provision*
  - Transactions by MiFID2 authorised firms (in same group)

A blue speech bubble with a white border, containing text. The text reads: "Everything hinges on accounting for quantities, especially total market volumes".

Everything hinges on accounting for quantities, especially total market volumes

## **Ancillary Activities Difficulties**

- Political intent to extend the scope of financial regulation
- One of the most contentious parts of MiFID
- It is clear that no licensing required if no speculative activity
- Hedging Definition – firms’ reorganization and relocation
- Not self-executing –annual application
- Highly problematic transitional regime
- Definition of spot vs physical forward

## What

- Definition of “*Commodity Derivative*”
- The definition of “commodity derivative” is defined in Level 1 and has quirks in its perimeter that will challenge firms’ and trading venues’ implementation and ongoing compliance with MIFID2
- “*Physically Settled*” power and gas instruments (“*derivatives?*”) traded on an OTF will be captured under REMIT, not MIFID2
- Clarification on “REMIT Carve Out” definition was set out in the 15<sup>th</sup> December 2015 Delegated Act from the EU Commission
- Nb: “*Securities based on a commodity underlying*” are included, although not shares nor bonds. This excludes the majority of commodity ETFs and ETNs



## MiFID2/R: Scope-Financial Instruments

### ANNEX I, SECTION C

- C(5):Cash-settled commodity derivatives
- C(6): Physically-settled commodity derivatives on a RM, MTF or OTF
  - *"...except for wholesale energy products traded on an OTF that must be physically settled"*
- C(7):Other physically-settled commodity derivatives
  - *"...not being for commercial purposes and having the characteristics of other derivative financial instruments..."*
- C(10): Exotics Derivatives
  - *"climatic variables, freight rates, inflation rates or other official economic statistics"*
- C(11):Emission allowances

### ESMA FINAL REPORT (19 December 2014)

#### C(6) *"Must be physically settled"*:

- *"wholesale energy products"* OTF exception
- Scope of oil and coal transitional treatment under article 95

#### C(7)

- Definition of *"not being for commercial purposes and having the characteristics of other derivative financial instruments"*

### Not addressed in Final Report

- OTF definition
- Treatment of booked-out/circled out markets

## ESMA Final Report Dec 2014 – Perimeter Guidance C(6)

### “REMIT” EXEMPTION

- “Wholesale energy products”
- Traded on an “OTF”
- “Must be physically settled”

### ESMA Technical Advice

*“Must be physically-settled”:*

- “Proportionate arrangements” for delivery
- “Obligations under the contracts cannot be offset against other contracts” (apart from payment netting)
- Operational netting (gross/net nominations)
- “Force majeure”, “bona fide inability to settle”, “default”

### OIL & COAL (TRANSITIONAL EMIR EXEMPTION)

- Exemption from EMIR clearing, risk mitigation and NFC+ threshold calculation treatment (July 2020 expiry)
  - NCAs to grant exemption (on a per contract basis)
  - Available only to NFC+s and firms which become MIFID authorised for the first time “as from 3 Jan 2017”
- **C(6) energy derivatives:** relate to oil or coal ; traded on OTF, and must be physically-settled
- **Oil:** “contracts having mineral oil, of any description and petroleum gases, in liquid or vapour form, including products, components and derivatives of oil and oil transport fuels, including those with biofuels additives, as an underlying”
- **Coal:** “contracts with coal, defined as a black or dark brown combustible mineral substance consisting of carbonised vegetable matter, used as a fuel, as an underlying”

## ESMA Final Report Dec 2014 – Perimeter Guidance C(7)

### C(7): Physical forwards not under C(6)

- Not spot
- Not for commercial purposes, and
- “have the characteristics of other derivative FIs”

### ESMA Technical Advice

#### *“Spot”:*

- 2 trading days, or
- Period generally accepted in the market ... as the standard delivery period, and
- No “understanding” that contract is to be rolled over

#### *“Commercial purposes”*

- Narrow category for energy balancing activity

### ESMA Technical Advice: “Characteristics”

#### Standardisation Criterion

- Price, lot, delivery date or other parameters determined principally by reference to standardised prices, lot sizes, delivery dates;

*And ...*

#### Trading Criterion

- Traded on a third country TV (*similar to RM, MTF or OTF*)
- Expressly stated to be traded on, or subject to rules of, a RM, MTF, OTF or third country TV
- *Or*
- equivalent to a contract traded on RM, MTF, OTF or third country TV (with regard to prices, lots, delivery dates)

## Time Lines

- Level 1 Directive & Regulation was finalized 17 January 2014
- ESMA provided advice to the EC on the Delegated Acts, Regulatory & Implementing Technical Standards at the end of 2014
- ESMA delivered draft RTSs on 28 September 2015
- ESMA will deliver drafts of remaining RTSs early 2016 and revisions in late 2016
- EC has not yet endorsed the RTSs or adopted delegated acts (*announcement likely next week*)
- EC to deliver Level 1 changes: Timing, Packages (?), SFTs (?) (*announcement likely next week*)
- They are subject to further scrutiny by EP and Council before they enter into force
- Current transposition deadline for MiFID2: Currently EU Member States have until 3 July 2016 to introduce national implementing measures (*this will likely change shortly*)
- Level 3 work: Rules, Guidelines and Q&A from ESMA Task Forces (*and FCA?*) during 2016...
- MAR/MAD2 implementation due Q3 2016 (*this will possibly be deferred*)
- 31 Dec 2017 Specialist commodity firm exemptions under articles 493/498 of CRR expire (*but likely extension to 31 Dec 2020*)
- 02 Jan 2018 MiFID2/MiFIR application (*announcement next week*)
- 2018-2020: Phase in of Data Dependencies and Best Execution (*may require further legislative change*)
- 3 July 2020 End of transitional period for oil & coal

# The OTF in MiFID II/MiFIR



*OTF will be subject to:*

- Investor protection
- Conduct of business
- Best execution
- Pre-trade transparency
  - Publish current bids and offers
  - Publish depth of trading interests at those prices continuously during normal trading hours
  - Including actionable expressions of interest
- Pre-trade waiver available
  - Large in scale orders or order held in management facility
  - Submitted indications of interest in Request for Quote
  - Voice trading system above a certain size which could expose liquidity providers to undue risk
- Post trade transparency
- Publish execution quality data
- Transparent non-discretionary rules
- Authorities can suspend trading
- Record orders
- Order handling

## EMIR – Demonstrating Discretionary Arranging

- LEBA instigated a *screen-assisted voice-executed workflow* approach which offers the option to market participants' to demonstrably execute either in a MiFID venue or using broker services which demonstrate a discretionary element of arranging (“DDA”)
- Voice broking uses technology for price discovery via indications of interest (IOIs), rather than for execution
- Counterparty given choice of either/both liquidity venues. If they opted-in for the broker execution, that trade will be subject to the off venue workflow. The workflow for trades executed between clients who have not opted into only MTF venue were not changed
- This process required system changes and modifications on venues offered by LEBA Brokers to clients and was rolled out between Dec 2013 and was fully operational by 15<sup>th</sup> April 2014
- All trades arranged by LEBA brokers acting as Professional Persons Arranging Trades [“PPATs”] need to be REMIT compliant

# Lessons from MTF / Non-MTF experience in C6 Commodities

- **LEBA firms current registered MTF platforms' offer a combination of discretionary and non-discretionary services.**
  - However for C6 Commodities the discretionary arranging is now segregated outside the MTF perimeter.
  - Under MIFID II the discretionary activity will be deemed as an OTF with one platform, acting as a system encompass both the matching of IOIs and Orders?
  - Under this approach whereby the system in totality is a discretionary one but it may contain orders
- **Clarity to the users at the point of initiation. The MTF / Non-MTF delineation was critical to users who were dependent upon knowing their NFC-/NFC+ status.**
  - Under MIFID II there are similar requirements for clarity related to thresholds, matched principal permissions, PERG and 2.i.(d).
  - The client needs to have surety on the venue outcome before the venue or the broker receives the client order it is at this point that discretionary services is applied



# Frameworks; Market Structure

*Post February 2014 World*

Pre-existing Broker Hybrid  
"Click-to-Trade"

"Click-to-Post  
Interest or  
Message"

"Squawk-to  
Trade"

---

MTF

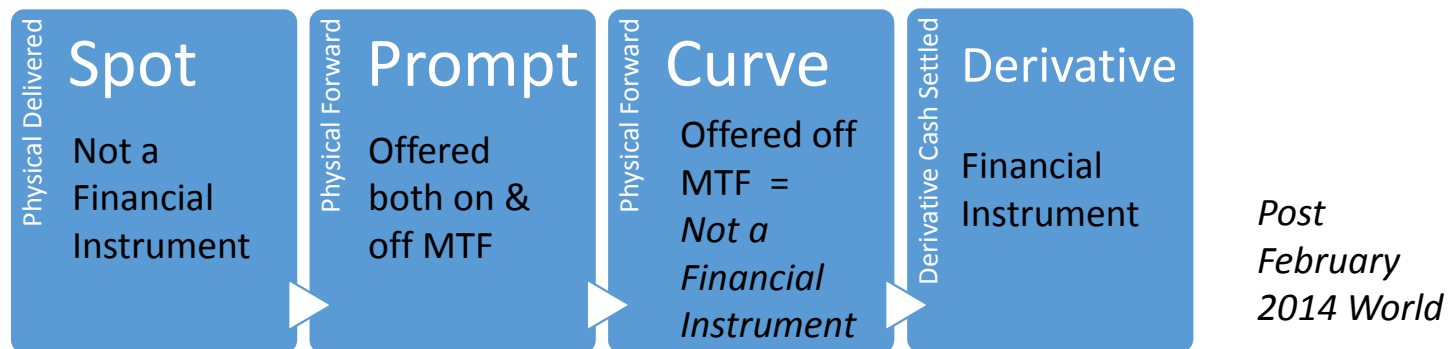
(direct client or agency access &  
interaction)

Non-MTF

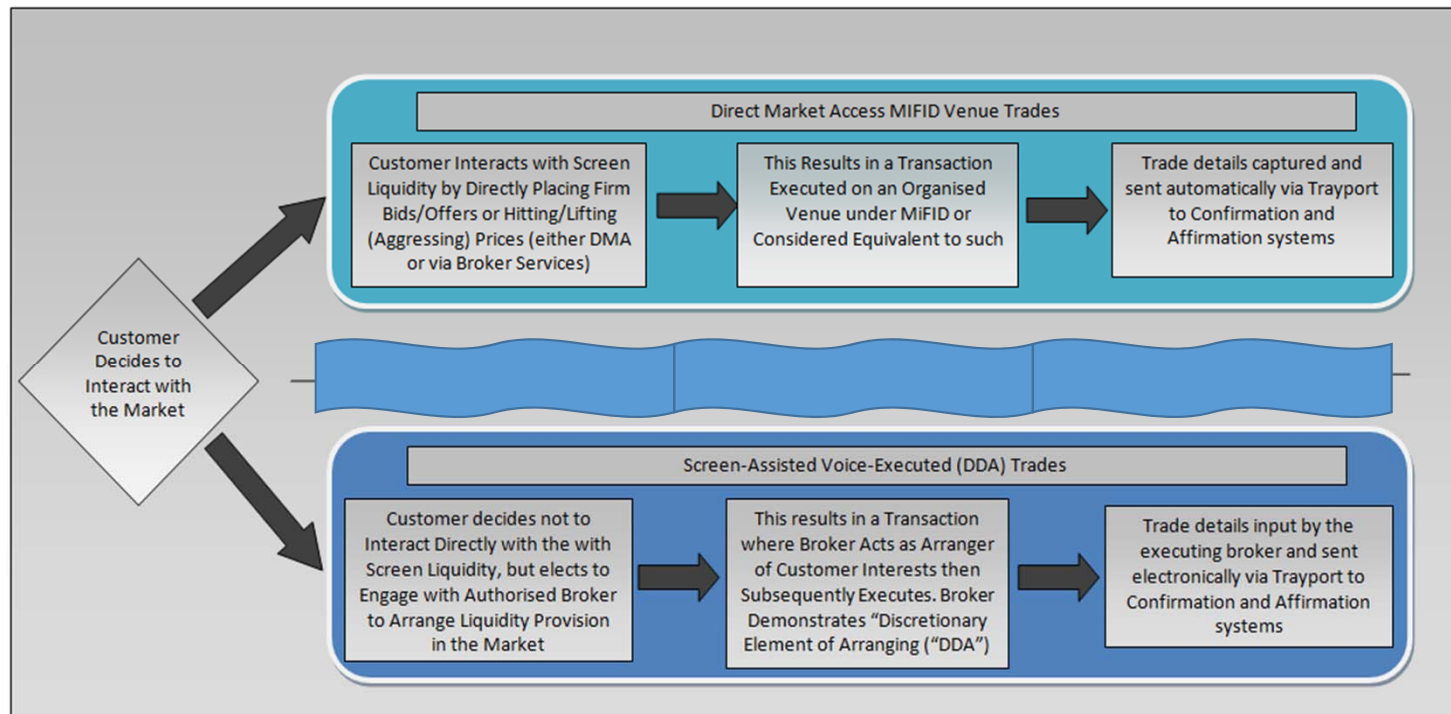
('Progenitor OTF' with  
requirement for Broker  
Discretion)



# Frameworks; Market Segmentation



## **LEBA Illustration for a Screen-Assisted Voice-Executed Workflow Approach**



- But... 'Null Hypothesis' – easier to prove 'non discretion' than the reverse
- How can these liquidity pools really be segregated

# Mechanics of the Changes



## Documentation

- **MTF Rulebook:** to be sent to clients December 2013
- Brokers may or may not require these to be signed and returned. Continued usage of the systems after the “Go-Live” date will deem the Terms of Business as accepted.
- **Terms of Business:** Broker Terms of Business: to be sent to clients by December 2013
- Brokers may or may not require these to be signed and returned. Continued usage of the systems after the “Go-Live” date will deem the Terms of Business as accepted.

## Process change

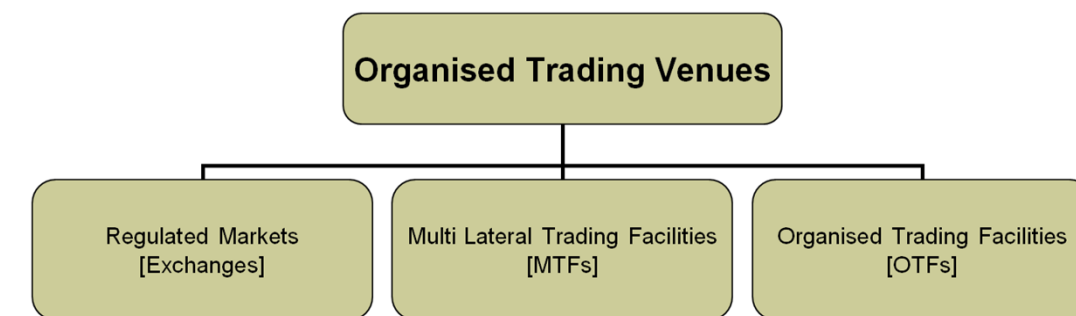
- **Trayport**
- Non-MTF matched orders enter pending negotiation status and subject to broker execution
- Counterparties to see names on pending negotiation trades
- Process changes to mitigate operational risk of pending negotiation status trades
- **WebICE:**
- New product set with different identifiers to be created for Non-MTF matched orders
- Non-MTF matched orders enter pending negotiation status and subject to broker execution
- MTF and non-MTF products available. Default is non-MTF
- Counterparties to see names on pending negotiation trades
- Process changes to mitigate operational risk of pending negotiation status trades

# Outcomes of the Changes



- **Successful in terms of Objectives**
  - Market trades on Non-MTF
- **Fragmentation of Physical Forwards from Derivatives**
  - 'Non MTF' Derivatives?
  - CFDs, Spreads and Cross-Hub Trading?
  - Split National Competent Authorities
- **Spot definition**
  - Confirmed as two “banking days” for Gas and Power , Prompt Month +3 for Physical Coal.
  - these transactions use existing workflow, labeled as non-MTF
  - “banking days” - banking system to both counterparties and the platform are open and available in their respective countries
- **Post Trade Issues**
  - REMIT Reporting
  - CCP Clearing and EMIR Timelines for Mandating
- **Basis for MiFID2/MiFIR OTF Boundaries**
- **Costs of Compliance/Trading**

# Energy Market Trading Platforms & Liquidity



- Liquidity Fragmentation and Segregation
- Extraterritoriality
- Market Abuse Framework; Transaction Reporting (TRUM) & Transparencies
- Financial Transaction Taxes

REMIT Compliant Broker Platforms

## The Discretionary Basis – *Level 1 Text*

The execution of orders on an OTF, must be carried out on a discretionary basis. An OTF operator may only exercise discretion in the following circumstances:

- *when deciding to place or retract an order on the OTF; or*
- *when deciding not to match a specific client order with other orders available in the system, provided it is in compliance with specific instructions received from a client and with its best execution obligations.*
- *For the system that crosses clients' orders the OTF operator may decide if, when and how much of two or more orders it wants to match within the system. In accordance with other requirements, for a system that arranges transactions in non-equities, the firm may facilitate negotiations between clients in order to bring together two or more potentially compatible trading interests in a transaction. The operator of an OTF will owe certain conduct of business duties to its clients including acting in accordance with their best interests, appropriateness, best execution and order handling*

## Demonstrating Discretion

**Will the NCA (FCA in UK) see a single system with the ability for discretion inherent as needing to display this all or some of the time?**

**What limits will the FCA place on evidencing and demonstration of discretion, given the level 1 text?**

- *when deciding to place or retract an order on the OTF; or*
- *when deciding not to match a specific client order with other orders available in the system, provided it is in compliance with specific instructions received from a client and with its best execution obligations.*
- *for the system that crosses clients' orders the OTF operator may decide if, when and how much of two or more orders it wants to match within the system.*

**In operating a volume matching auction, because the venue uses discretion to set the price, is this necessarily an OTF?**

*Authorisation Process*

**What pragmatic possibilities are in place for the common requests for waiver permissions and licences?**

## What We Know

- FCA considers platforms as a single system with a set of inherent characteristics. Therefore the system as a whole will need to display the (capacity for?) discretion.
- FCA understands that clients need surety of venue obligations and processes before entering communications.
- Clients will be treated within the system rather than agency or introduced to it.
- MTFs & OTFs will need separate rulebooks and codes but not separate entities, staff nor on-boarding
- If the broker acts outside the venue then he may need to be viewed as acting the in the capacity of agency on behalf of one counterparty client. PFOF rules may apply.



## What We Do Not Know

- Will the FCA see a single system with the ability for discretion inherent as needing to display this all or some of the time?
- What thresholds will the FCA place on evidencing and demonstration of discretion, given the level 1 text?
- Will the FCA allow the OTF to be a direct participant in any MTF?
- How can two OTFs interact if at all given the level 1 text?
- Can the order and IOI stacks in the MTFs & OTFs be co-mingled at the point of venue?
- How does an IOI become an A\_IOI and then an Order. What records and evidencing are required?

## OTF – MTF Interaction

**The current non-MTF platforms run as hybrid systems interacting with order matching on the associated MTF.**

- The OTF as a system containing brokers acting to arrange and bring about transactions
- Arranging versus acting on behalf of (or as agent to) any particular interest.
- OTF will be an ordinary participant/member of that venue's own MTF or any other third party MTF/RM alongside other participants
- The OTF has discretion on the presentation of the IOI as an order for execution, time, price, volume and on alleged execution will be considered to be executed under the OTF rules.
- All hybrid activity be deemed an OTF venue...

**Discretionary (Voice broker) order matched against resting order as an OTF trade or OTF/MTF Trade? ('MIC Code' and/or 'OIC Code')?**

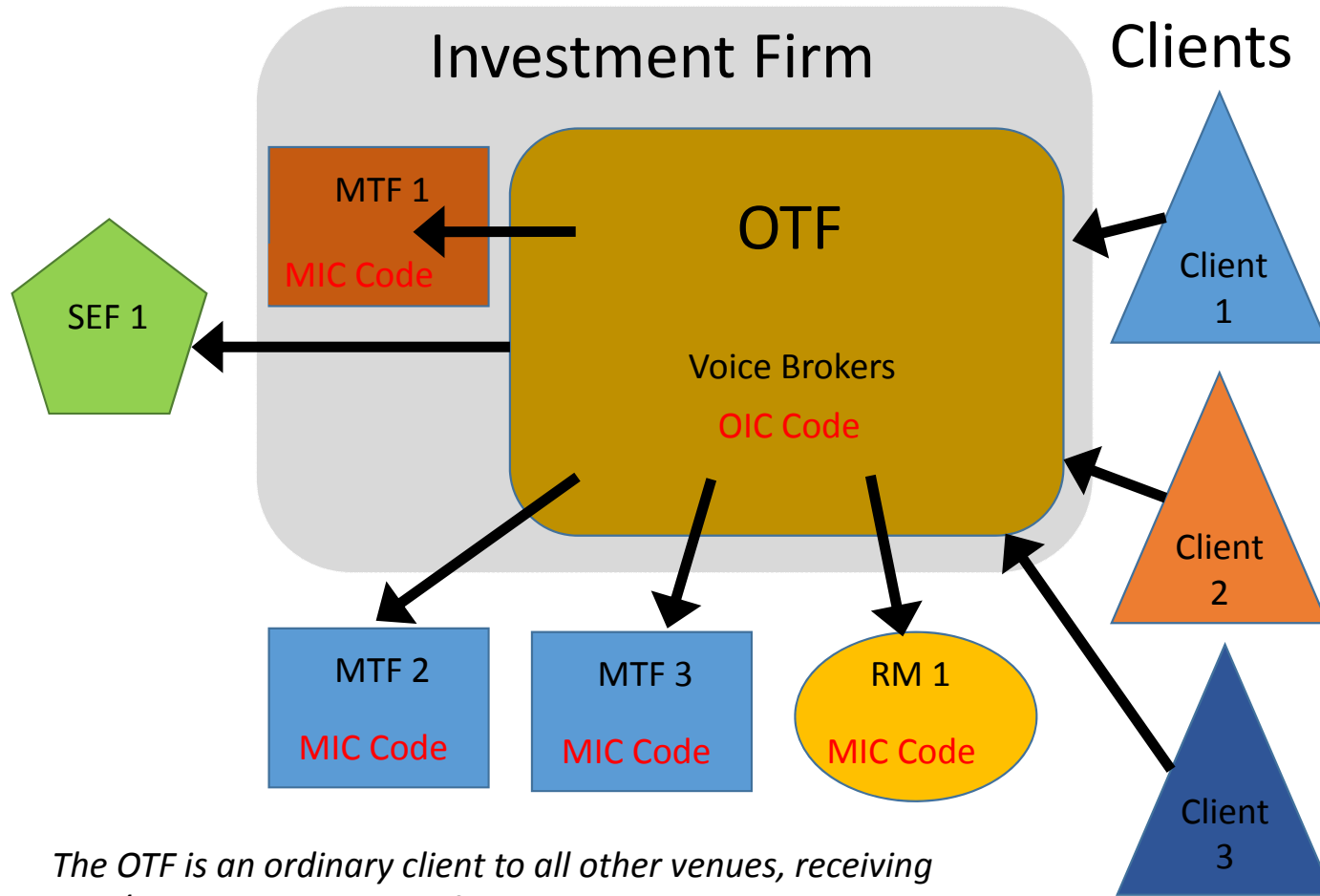
- Where a voice broker has access into a pool of liquidity on an MTF, and executes the order, that execution will be deemed an OTF trade due to the voice broker discretion of when to execute the trade.
- Does that trade become registered as an OTF trade?
- Could one counterparty side of the trade be OTF [OIC Code] coming from a deployment of discretion and the counterparty side be an MTF [MIC Code] coming from a resting order

**MTFs & OTFs requiring separate legal entities, staff nor on-boarding of clients?**

**How do OTFs interact given the level 1 restrictions**

## **Blocks and CLOBs: Venue Interaction with RMs**

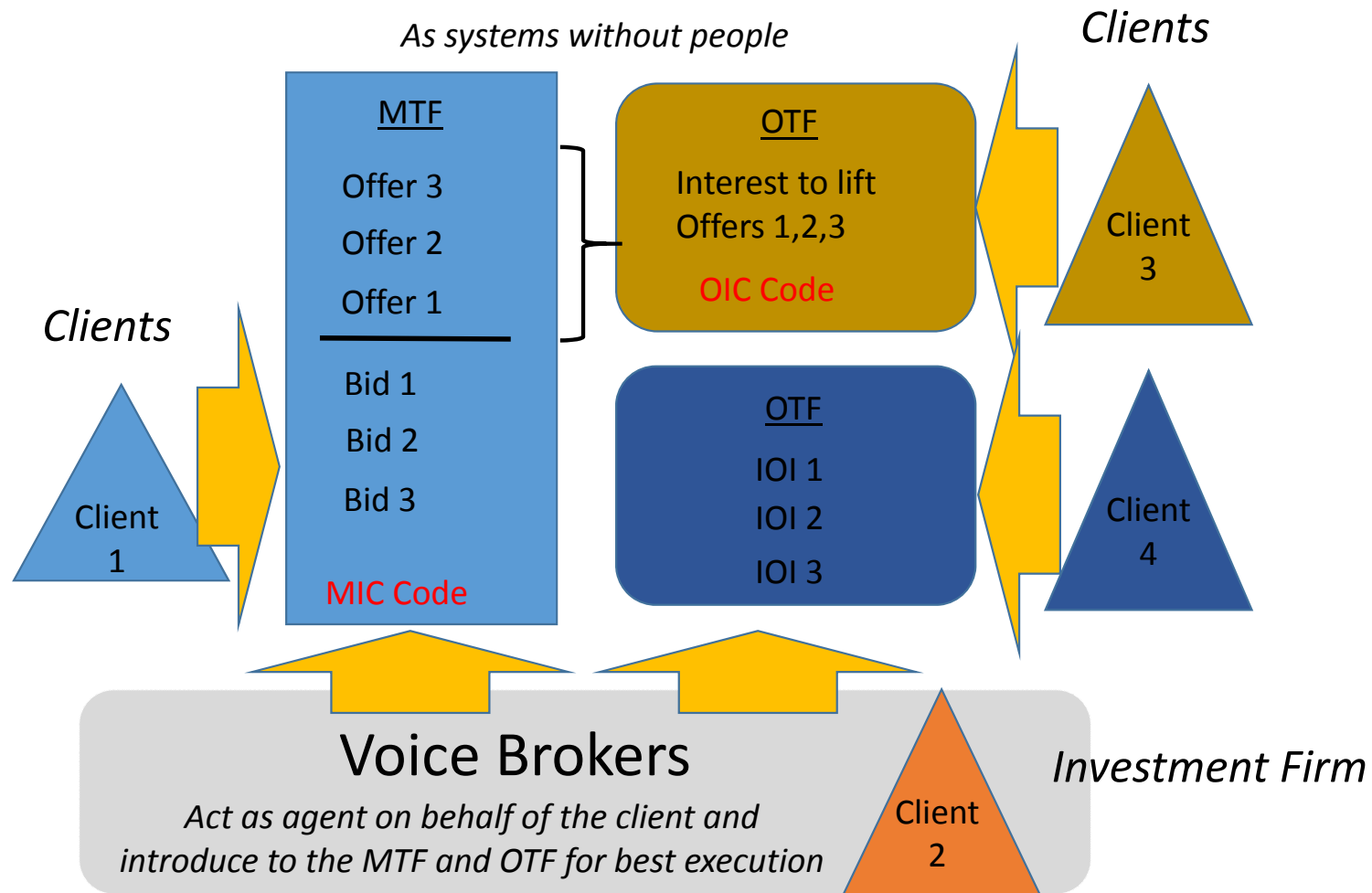
- **Standard practice of Blocks in the US**
  - *'Equivalence' versus 'Deference'*
  - Prudential Treatment of Margin and Risk
- **Whose Rules?**
  - Multiple rulebooks versus *'open access' and EEOOTCs*
  - Role of supervision
- **Clearing**
  - Blocks versus Registering
  - Novation versus Tear Ups
- **The example of EEX/ECC**



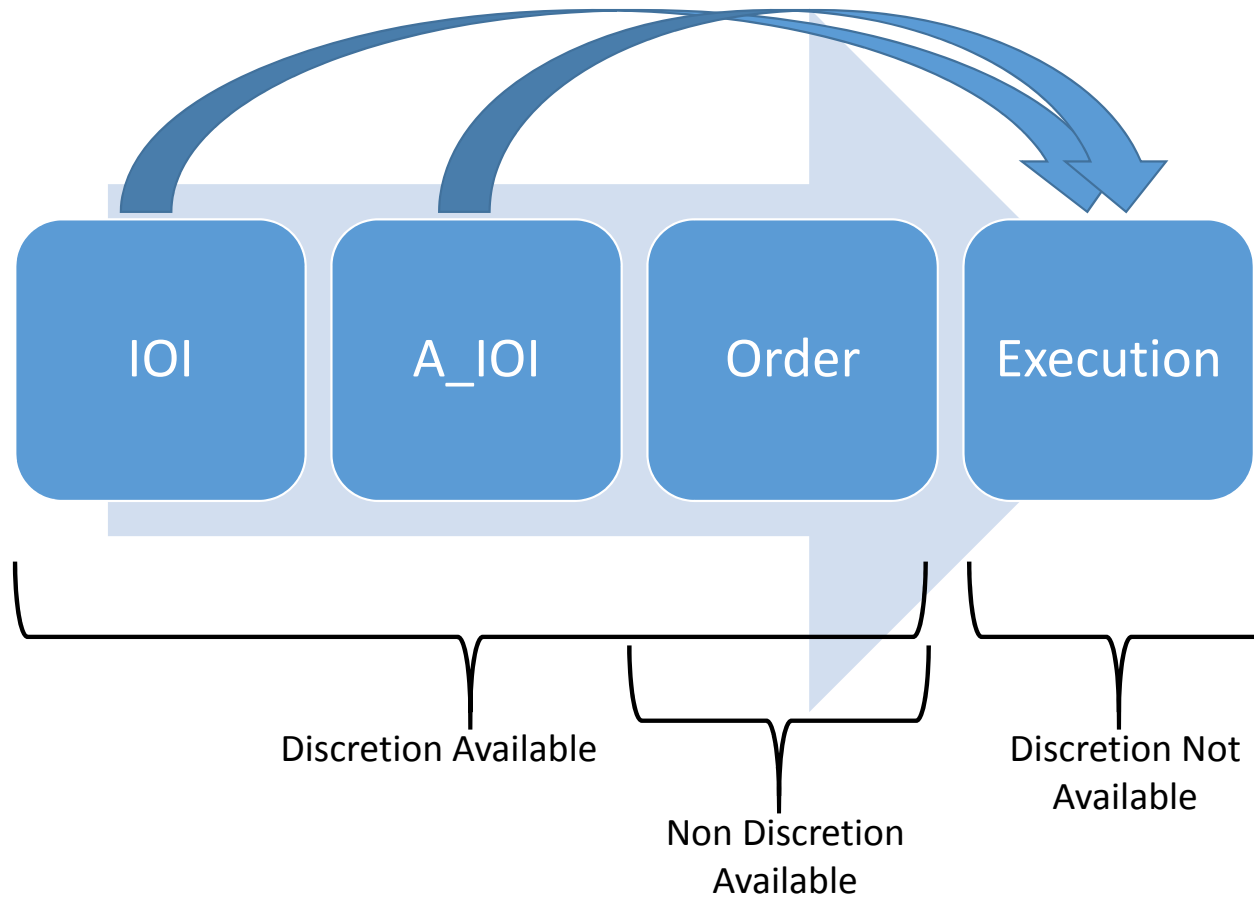
*The OTF is an ordinary client to all other venues, receiving MIC/RM or SEF coded confirms and passing on OIC codes*

# Platforms

*As systems without people*



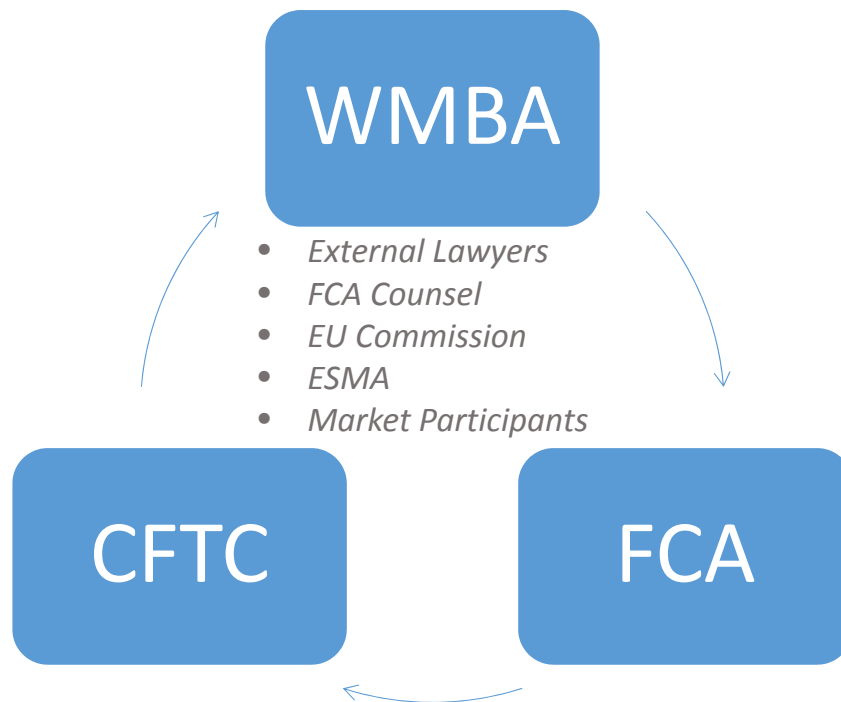
## Progression of an interest / workup



## Handling of IOI, A IOI, Orders

- Where the client gives the broker OTF an Indication of Interest [IOI] above the SSTI, the broker will only make public the indicative standard size unless the IOI becomes an Actionable Indication of Interest [A\_IOI] as an allege is created pending the execution of the trade.
- Where the voice broker has pre-arranged an off venue order match between two clients, does the OTF venue have to offer block crossing facility similar to regulated market block trade facility?
- How does an IOI become an A\_IOI and then an Order? What evidences and records are required?
- Can the IOI, A\_IOI and order stacks in the MTFs & OTFs be co-mingled at the point of venue with suitable identification?
- Could the Broker ever act outside the OTF or MTF system in the role of an 'Introducing Broker' or in an agency capacity?
- Can an OTF receive streamed indications and streamed prices? If the prices are streamed as factor prices such as volatility or spreads, are these then necessarily OTF venues?

## “MTF / Q-MTF”



The Issue: For Derivatives Dodd/Frank has a strong extraterritorial impact. The market has migrated away from the locus of ‘US Persons’.

The Solution: Substitutive Compliance. Altering and Clarifying the definitions of what constitutes a venue

The Implementation: MTFs in the UK working with both Market regulators in the US [CFTC] and regulators in the EU [FCA and ESMA] to adjudicate on an outcome.

The Impact: No Regulatory Trust and a failure to implement. Another fragmentation of liquidity pools