Risk.net

Financial Risk Management News and Analysis

Exchanges, energy brokers jostle for position ahead of Mifid II

EEX foray into non-MTF platforms sparks outcry from brokers

Ever since it became clear energy firms would be drawn into the net of new European Union financial regulations, they have been dissecting the rules in search of a way out.

Potential strategies to avoid the EU's second Markets in Financial Instruments Directive (Mifid II) include cutting back on commodity derivatives trading activities that could be considered speculative; pushing those activities into **a separate unit**; or even relocating them **outside of Europe** altogether.

Yet another potential solution is to switch from derivatives trading to physical transactions, executed on a different kind of platform where trades are exempt from the rules. Non-multilateral trading facility, or non-MTF, platforms might allow firms to trade power and gas without worrying about Mifid II, which could force EU energy companies to set aside **billions of dollars** to comply with capital and margin requirements.

But the devil is in the details – and nobody quite knows whether the non-MTF platforms available will really provide energy firms with a get-out-of-jail-free card.

On July 1, the newest non-MTF platform entered the fray. Launched by the Leipzig-based European Energy Exchange (EEX) and Paris-based Powernext, in which EEX owns a majority stake, the platform lists a suite of physically settled power and gas derivatives. These "are not considered as financial instruments under Mifid II", EEX says in its marketing materials for the new platform.

That is an important point, because if EEX's new suite of products do not fall within the definition of financial instruments, an EU energy firm that trades them would not need to count them towards the so-called 'ancillary business exemption' thresholds. Firms that cross these thresholds would be dragged into the scope of Mifid II, which is set to take effect in January 2018.

"Because of all of this pressure created from financial regulation, market participants are looking at ways of trading energy without it counting towards their ancillary activity threshold," says Jasper Jorritsma, senior policy adviser at Dutch financial regulator, Autoriteit Financiële Markten. "There are serious concerns from energy companies about having to become an investment firm under Mifid II. This seems to be a response to demand by the venues."

Before EEX launched its new platform in July, the non-MTF space was largely the purview of European energy brokers. Brokers such as UK-based Icap and Griffin Markets, and New York-based GFI Group have offered non-MTF execution of physical power and gas trades for the past several years, having introduced them ahead of a previous regulatory deadline – the February 2014 launch of trade reporting under the European Market Infrastructure Regulation (Emir).

Now, the brokers are unhappy EEX is trying to muscle in on their territory. The debate is also raising questions about what, exactly, separates non-MTFs from other kinds of trading venues.

Blurred lines: OTFs and MTFs

Prior to Mifid II, EU financial rules had two labels for trading venues: regulated markets (RMs), which effectively means exchanges, and MTFs, which are generally broker-run matching platforms. Mifid II will introduce a third kind of venue, the organised trading facility (OTF). Unlike MTFs, which must be non-discretionary in nature, OTFs use discretion in the process of lining up buyers and sellers – for example, in deciding when to place or retract an order.

The significance of the OTF venue type is that Mifid II alters the previous text of the rules, Mifid I, to remove natural gas and power forwards executed on OTFs from the definition of a financial instrument, as long as they "must be physically settled". The rationale behind the exemption is that such trades are already covered by the EU's Regulation on Wholesale Energy Market Integrity and Transparency (Remit).

Some regulators have criticised the so-called 'Remit carve-out' for allowing a large swath of EU energy trading to escape Mifid II. "We do not believe that creating regulatory arbitrage in favour of OTFs against regulated markets and MTFs was a Mifid intention, especially when the consequence is a carve-out from financial regulation," Vincent Derbali, an official at French financial regulator Autorité des Marchés Financiers (AMF), told *Risk.net* in an**interview** last year.

Be that as it may, physically settled transactions on OTFs have emerged as a potential escape hatch for utilities, commodity trading firms and other physical market participants unhappy about Mifid II. Only the term 'OTF' is not quite correct – platform operators cannot actually call their venues OTFs, because Mifid II has not taken effect yet and, at present, there is no way to formally register an OTF. That has led to the use of the phrasing 'non-MTF', a term of art for venues that will eventually attempt to become OTFs. EEX, for instance, says it will seek OTF status for its new non-MTF platform as soon as it can.

Courting controversy

Some market participants are sceptical about the legitimacy of EEX's new venture. Critics say it uses a central limit order book to match trades, just like an exchange, and they argue that such a platform should not be considered discretionary. By allowing such a platform to be classified as an OTF, they say, regulators could create an uneven playing field between brokers and exchanges.

"If you have a human being and he has got prices and phone lines and they all ring at once and he picks up one of them randomly, that is true discretion," says Ben Pott, London-based group head of regulatory affairs at Icap. "If you have a human element in the decision process, that to us goes into the heart of what discretion means in Mifid II."

"If you have a human element in the decision process, that to us goes into the heart of what discretion means in Mifid II

Ben Pott, Icap

EEX declined to arrange an interview for this article, but a spokesperson provided written responses to questions from *Risk.net*. When asked whether the new non-MTF platform was truly discretionary, the spokesperson points to a clause in its terms and conditions that states the platform's operator may "reject, re-arrange orders in or retract orders from the order book at any time".

Christiane Leuthier, London-based senior director of commodities at FIA, says the distinction between MTFs and non-MTFs has always been somewhat unclear. Brokers that began offering non-MTF services ahead of the 2014 Emir deadline were also unable to articulate what exactly made them ‘discretionary', she adds.

"It was always a bit of a grey area," Leuthier says. "The big question before [EEX's new platform] was launched is: how do you demonstrate that you have that discretionary element, and how will it be exercised? Presumably, once Mifid II takes effect in 2018, EEX intends the platform to be recognised as an OTF, but that will require confirmation closer to the time… Our members are asking how many OTFs there are going to be under Mifid II and how it will all work."

What is discretion?

Regulators have yet to spell out the details of what makes a venue discretionary. A spokesperson for the European Securities and Markets Authority (Esma) says the Paris-based agency is working to provide clarity on the definition "hopefully before the end of this year".

That said, it will ultimately be up to the national competent authorities (NCAs) in each EU member state to look at Esma's rules, compare them to what venues are doing and authorise them as OTFs. Mifid II says NCAs may ask platform operators for a detailed explanation as to why their venue does not fit into any other designations – such as RMs or MTFs – before granting an OTF licence. An NCA may also query the applicants on how orders are retracted and how their platforms match buyers and sellers.

EEX says it is "well equipped" to obtain an OTF licence for its new platform and adds that Bafin, the German regulator, had no objections to the launch going forward. "Prior to introduction, we discussed our offering intensively with our relevant committees and regulatory bodies, especially with Bafin, who confirmed their non-objection," a spokesperson for the exchange says.

Some in the brokerage community are less than pleased. One London-based commodities broker accuses EEX of exploiting a flaw in EU regulation, for example, and blames Bafin for letting it go ahead: "The loophole is only as big as Bafin allows it to be," the broker says.

Bafin declined to comment on the non-MTF product or the correspondence it had with EEX. Meanwhile, Esma warns it is too early to make assumptions about which venues might win OTF status from their NCAs. "As Mifid II will only apply from 2018, OTFs are not yet operational," the spokesperson says. "Therefore, it also appears too premature to judge whether or not some non-MTF platforms have already incorporated the discretionary element or may prefer to wait for Mifid II to enter into force."

Regulatory arbitrage

Lawyers and market participants say there is a risk of regulatory arbitrage between different EU member states unless Esma comes out with clear guidance on the definition of discretion.

"The OTF is not yet clearly defined and, without a clear mandate under Mifid II, it could ultimately end up being decided by member states on a jurisdiction-by-jurisdiction basis," says Adam Topping, London-based special counsel in the energy and commodities group at law firm Cadwalader, Wickersham & Taft. "As such, it is possible there will be diverging interpretations as to exactly what an OTF is."

There is also the possibility that venues currently touting themselves as non-MTFs might end up falling into the MTF category after all, depending what definition of discretion Esma comes up with.

The OTF is not yet clearly defined and, without a clear mandate under Mifid II, it could ultimately end up being decided by member states on a jurisdiction-by-jurisdiction basis

Adam Topping, Cadwalader, Wickersham & Taft

"Esma is currently considering the question about what is discretion under Mifid II," says Jorritsma at the AFM. "So it is very well possible that Bafin or the AMF now gives one answer and says: ‘yes, this is discretion', and subsequently Esma comes out with guidance that says: ‘no, it's not' – in which case the non-MTF platform under Mifid I might find itself being an MTF platform under Mifid II."

Industry sources say the UK's Financial Conduct Authority (FCA) has communicated an understanding of the definition of discretion that would not permit EEX's new platform to be classified as an OTF. In the FCA's worldview, an OTF would need some sort of human intervention or individual decision-making process to link up buy and sell orders, as opposed to an electronic matching system, these sources tell *Risk.net*.

The FCA declined to comment. A source at the agency says the FCA is working to reach "a common interpretation, through Esma, on a wide range of Mifid II issues to assist the industry".

A change of heart

Before EEX got into the non-MTF game, exchanges characterised the rival platforms as a "threat" to market integrity.

In response to a 2014 consultation paper on Mifid II, Europex, the Brussels-based energy exchange group of which EEX is a member, warned the carve-out for physically settled gas and power contracts could lead to undesirable results.

"In many regions in Europe today, more than 80% of gas and power derivative trading is still done through broker platforms (often through non-MTF platforms that are likely to become OTFs in the future). In certain European energy commodity markets, however, volumes of exchange-traded derivatives have fortunately steadily increased with a positive impact on transparency and a reduction of systemic risk... This positive progress is now under threat," Europex said.

"Many market participants expect that a significant portion of the volumes currently traded on regulated markets would shift to OTFs. They would indeed try to avoid a regulatory trading environment which they perceive as more restrictive whilst similar products with the same economic rationale are available in a less regulated framework."

Now, after the launch of EEX's new platform, other exchanges are said to be exploring the idea of launching their own non-MTFs.

"It is an issue that other supervised venues are looking at very closely," says Jorritsma at the AFM. "They are obviously worried they might lose business to the non-MTFs. The irony is that for Mifid II, the continental European platforms have been lobbying hard to ensure those broker networks would get regulated, but some are now setting these platforms up themselves."

Chicago-based CME Group says it is speaking with market participants to understand how OTFs will fit into the existing market structure, but "has not determined whether there is a market need to launch an OTF", according to a spokesperson.Atlanta-based Ice declined to comment, but a source close to the exchange operator says it is not currently planning to launch non-MTF venues.

The irony is that for Mifid II, the continental European platforms have been lobbying hard to ensure those broker networks would get regulated, but some are now setting these platforms up themselves

Jasper Jorritsma, Autoriteit Financiële Markten

Reluctant to trade

Amid the uncertainty over what will count as an OTF, market participants contacted by*Risk.net* say they are reluctant to trade on the new non-MTF platform being offered by EEX.

"People have been asking whether this will work or not, [and] maybe that explains why people are holding back," says a London-based compliance manager at an oil and gas firm. "We are interested in different options but we wouldn't necessarily go for it. It is a big problem for the platforms, but this is a potential problem for us as well."

Similarly, a regulatory manager at a European utility says many market participants will be unwilling to use EEX's new platform until Esma publishes a Q&A on the topic as part of the level 3 documents on Mifid II, helping to clarify the boundary between OTFs and MTFs.

"My company specifically has not started trading the products, but it is a good opportunity to look at this. To be able to cope with a Mifid II world, the products probably need to go through a more in-depth test," the regulatory manager says. "The issue is not so much about the products themselves, but the fact that you need to measure those products against rules that are not yet in place."

Figures provided by EEX do not suggest a huge groundswell of interest in the exchange's non-MTF offering in its early days. To date, 10 participants have registered to trade on the new platform, including utilities, municipal power suppliers and commodity trading firms, according to EEX.

Total trading volume for July and August in non-MTF German power futures – the most active product on the new platforms – amounted to 4.9 million megawatt-hours, or about 1.6% of the volume traded on EEX's RM platform during the same period.

"After the launch of the non-MTF trading venues in July, EEX has seen trading activity, albeit on a much lower level than on the regulated market," says the EEX spokesperson. "These trades show that our non-MTF concept works."

The meaning of ‘must'

Besides the debate over what makes a trading venue discretionary, EEX's new platform has also raised questions about what it means when a contract ‘must be physically settled'. That is a trickier issue than it might seem at first glance, market participants say.

According to Esma's delegated acts for Mifid II, released in April, for a wholesale energy contract to fall in the ‘must be physically settled' category, it may "not allow either party to replace physical delivery with cash settlement".

EEX believes its non-MTF futures meet that requirement. A spokesperson for the exchange points to the rulebook for European Commodity Clearing (ECC), the clearing house for EEX, which states that the contracts "grant the trading participants and ECC a right to demand physical settlement of the contract instead of financial settlement".

Such language suggests the contracts ‘can' be physically settled – not that they ‘must' be physically settled, according to some observers. "The problem is, it is not just a question of physical settlement, it is a matter of what ‘must' means," says the regulatory manager at the European utility. "It makes me laugh, because there are so many conditions underlying that, for instance... an option for cash settlement, and that could become problematic."

Alexander McDonald, chief executive of the London Energy Brokers' Association, says the clearing process for EEX's new platform culminates in the physical nomination of power into the transmission system. So the exchange is making the case that settlement may occur as physical delivery.

"Historically, there has been a more formal division between the markets that are physically settled or financially settled, and of these, central counterparty clearing is seen as cash-settled," McDonald says. "But this is now blurring for a variety of reasons, including regulations."

So will EEX succeed in providing market participants with an escape hatch from Mifid II? Time will tell. It depends on whether the exchange can register its new platform as an OTF and win ‘must be physically settled' status for the contracts traded on it.

"EEX's next task is to ensure the trades comply with the [Remit carve-out] requirement... If they are successful in that – and we don't know that they are – then there will be a continuing advantage to trading on that platform after Mifid II starts," says Aviv Handler, managing director of London-based energy regulatory consultancy ETR Advisory. "If they fail, then that advantage goes away."