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Q&A: French regulator defends Mifid II commodity rules

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19 Nov 2015, Stella Farrington, Energy Risk

Vincent Derbali may not be widely known among energy traders, but as a member of the commodity derivatives task force of the European Securities and Markets Authority (Esma), he helped craft a controversial set of rules that the continent's energy industry is working frantically to undo.

On September 28, Paris-based Esma released final draft regulatory technical standards (RTS) for the reworked Markets in Financial Instruments Directive (Mifid II). European Union energy firms have been vehement in their criticism of the proposed rules, saying they will dampen liquidity in commodity derivatives markets and curtail hedging.

At the heart of industry concerns is the so-called 'ancillary business exemption' test, which determines whether nonfinancial firms that trade commodity derivatives will come under the scope of Mifid II. The test is intended to identify firms with high levels of speculative trading activity in commodity derivatives. Energy firms say, however, that the test is badly designed and will capture firms whose trading activity is relatively small compared to their primary commercial business.

Firms that fall within the scope of Mifid II face costly, bank-like capital requirements under the fourth Capital Requirements Directive (CRD IV) and would lose a valuable hedging exemption under the European Market Infrastructure Regulation (Emir). Industry groups fear the resulting costs could be so punitive that firms will simply withdraw from commodity derivatives markets before the legislation takes effect in January 2017.

Derbali – a financial policy adviser for commodity derivatives markets at the Autorité des Marchés Financiers (AMF), the French regulator – offers a different view in an interview with *Risk.net*.

Employed with the AMF since 2012, Derbali is tasked with monitoring how Mifid II, Emir and other EU regulations are impacting the commodities markets. He has also been one of the more outspoken members of Esma's commodity derivatives task force, which helped develop the portions of the RTS related to energy and commodities. In Derbali's telling, the rules were carefully crafted to target speculators and true hedging transactions should be unaffected.

Do you have a sense of how many commodities firms will be caught by Mifid II?

Vincent Derbali: That's a difficult thing to predict. The regulation has the clear intention of catching more commodity market participants than [are now] under Mifid I. However, we strongly believe that only those market actors that should be regulated due to their important or disproportionate non-hedging activities will exceed these thresholds. We'll see how the market will react, but we don't expect many new Mifid-licensed entities.

Are you concerned about firms pulling back from commodity derivatives and doing less hedging to avoid being caught by Mifid II?

VD: Commodity firms over or close to the threshold indeed will have to seek authorisation or reduce non-hedging activities. But they have the choice. This is a strategic decision they will have to make. Additionally, according to Esma's RTS, only the part of a firm's activity that doesn't qualify as hedging, if above the thresholds, needs to be authorised. Commercial and hedging activity should not be affected by this regime. A firm can decide if it wants to reduce non-hedging activity or, if it wants to continue with it, it will still have the option of developing a dedicated subsidiary subject to financial regulation.

Industry groups have been sharply critical of the ancillary business test. Under the test, a firm must work out its total non-hedging trading activity in commodity derivatives as a percentage of its 'main business', with the main business defined as the firm's total EU trading activity in commodity derivatives. Many firms say it is misleading to use total trading as a proxy for the size of their main business, because it ignores the fact that energy companies often have major capital invested in hard assets; so the test makes their non-hedging trading activity seem to be a larger part of their business than it actually is. Why did Esma design the test this way?

VD: We're well aware that the main business test is a major concern for market participants. Trading as a measure for the main business won't take into account, for example, the part of commercial activity that isn't hedged. However, when it comes to trying to capture disproportionate speculative activity in relation to the activity of the group, we do believe that trading is the right proxy. Indeed, if you have a small [amount of] speculative activity, it's going to come out as a small percentage of your overall trading activity and of the [total] market share. The objective of the test is indeed to capture disproportionate speculative activity. Additionally, this approach has the advantage of using existing data. This means that it won't impose additional requirements on market participants.

An earlier proposal from Esma featured a different kind of test, called the 'capital employed test', which used accounting measures of capital to determine the size of a firm's main business. Do you think this test could be brought back?

VD: Esma's December 2014 consultation paper did propose a main business test based on a capital employed approach, but most of the industry responses to the paper sharply criticised this approach. There's an absence of common accounting standards across market participants from the small agricultural co-operatives to the big energy producers. When you are targeting a few dozen firms to be caught by the new Mifid regulation, it is disproportionate to put thousands through an administratively burdensome capital employed test.

Industry groups have acknowledged that and proposed a dual-track approach whereby smaller firms could use trading as a proxy for their main business, but any firm wishing to use the capital employed test could do so as well. Do you think that could work?

VD: We don't believe that adding further options into a regulation that is already complex is the right answer. We don't think that small actors would accept... not [being] subject to the same rules as larger firms. Even among the big energy actors, we couldn't expect common accounting practices in the application of a capital employed approach. It would require more work and a greater administrative burden, and that was something Esma was keen to avoid.

The second part of the ancillary business test calls for firms to measure their non-hedging activity against the total size of EU commodity derivatives markets in things such as oil and products, natural gas and power, but there is no publicly available data on the size of these markets. Where can firms get this data?

VD: That is a legitimate concern. We acknowledge that market participants need clear numbers on the market size to apply the test. Although Esma is not obliged to provide these numbers, we believe it should do so. We'll work with Esma to help ensure it is in a position to publish this data annually.

Data on the size of these markets should, in theory, reside in the trade repositories (TRs) set up under Emir to allow EU regulators to monitor trading activity in over-the-counter derivatives. But there are concerns about the low quality of TR data. Do you share those concerns?

VD: We expect that data quality will improve over time. In the meantime, under the Mifid [ancillary business] exemption test, we have set the initial market share thresholds quite cautiously to take into account imperfections in data quality and availability. We can potentially adjust the thresholds lower with time. It's important that work is done to improve data quality over time.

What should firms be doing now in the absence of accurate data on market size?

VD: There are many things firms can start working on and I'm sure they have. The first thing is to try to work on the distinction between hedging and non-hedging activities. They can also start discussions with regulators to explain what their hedging activity is. Firms are required to use data from July 2015 to June 2016 for their first calculation of the exemption test, which gives them around six months to carry out the test to see if they need a licence before the regime takes effect in January 2017. We are aware that this is a short time. We are already engaged in discussions with the biggest commodity firms, and I believe if some of them need to ask for a licence we'll already be [aware of] that.

Yet another difficulty EU energy firms are facing as they try to carry out the ancillary business test is a lack of clarity over which products will be in the scope of the regulation. Most physical gas and power contracts are expected to stay outside of Mifid II due to the carve-out for products that fall under the Regulation on Energy Market Integrity and Transparency (Remit). In addition, the rules contain an exemption for wholesale energy products that are traded on an organised trading facility (OTF) and that "must be physically settled". But it isn't known yet which trading platforms will register as OTFs. Have you been speaking to market operators about their plans with respect to seeking OTF status?

VD: Yes, we are in discussions with trading platform providers to see if they want to become OTFs. OTF licences will not start before 2017, so it's an ongoing process. But identifying OTFs is indeed very key for understanding what's in scope under Mifid II. We already know that some market participants have the intention of developing OTF-registered platforms, but we won't be able to have a clear picture of the new market structure before 2017. Moreover, energy markets might take a few months, or even a few years, to adapt to the new regulatory structure.

There's a significant chance that fewer gas and power contracts will qualify as financial instruments because of this exemption. For that reason, France was opposed to this proposal when negotiating the directive. I personally believe, when it comes to power and gas contracts, there will be a switch of liquidity out of [Mifid-classified] regulated markets and multilateral trading facilities (MTFs), where gas and power contracts would be subject to financial regulation, into newly designated OTFs. As a result, there will be a switch of volumes from contracts considered financial instruments to contracts deemed physical contracts outside the scope of financial regulation. Although these contracts will hopefully still be subject to Remit, they would not be covered by Mifid anti-speculation provisions on commodity derivatives, such as position limits.

Doesn't this run counter to what Mifid II is trying to achieve?

VD: Completely. 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.

With Mifid II, regulators are also seeking to impose speculative position limits on commodity derivatives contracts traded in the EU. In the RTS, Esma has set the parameters for the position limits regime at a baseline of 25% of deliverable supply for spot contracts and 25% of open interest for other contracts. The limits can be adjusted from that baseline up to 35% or down to 5%, and national regulators are now tasked with identifying and setting limits on every contract in their jurisdictions. How will you go about this task?

VD: There's a lot of work for us to do! This regime may apply to several thousand contracts, compared to the US scheme, which covers only 28 contracts. But the concept isn't new for us. Many contracts, especially exchange-traded ones, are already subject to similar position limits. We've already had discussions with exchanges and clearing houses over position limits and we've already worked on the numbers for some contracts.

We do believe that Esma's proposal provides the flexibility needed to deal with the specificities of different commodity markets while meeting the need for a harmonised methodology across member states. It's very useful to have some flexibility at the national level in adjusting the limits according to the measures set by Esma, such as the number of market participants and volumes traded in the market. We think this will be a useful and efficient tool for us.

It will be Esma's role to validate every single limit set. This will take time and will probably involve some adjusting to ensure the limits answer to the objectives of Mifid.

How often will the limits change?

VD: We don't want position limits to change on a daily basis, as we want market actors to have as much clarity as possible. But we also want them to adjust to the evolution of the market. There will be frequent review of the limit levels by regulators – possibly annually – and the possibility of adjusting them [if there is a] change in market fundamentals.

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