

# Regulatory requirements for commodity and energy trading – Update on MiFID II, REMIT and MAD II

## **MAD II/MAR state of play**

*The Market Abuse Regulation (MAR), which took effect on 3 July 2016, together with the Market Abuse Directive (jointly referred to as MAD II) now regulates European financial markets with a view to the risk of market abuse and manipulation and thus sets rules for the conduct of market participants. After it was initially unclear how market participants were defined exactly, it quickly became apparent that a wide range of financial instruments and trading venues are affected by the general scope of these regulations, making it necessary for most companies to address this issue.*

Due to the wider scope of application of the MAR compared to the Market Abuse Directive (CSMAD), many companies conducted impact analyses to determine whether their financial instruments fall within the scope of the regulation and/or trading activities occur at affected trading venues. Depending on the extent affected, suitable measures have to be implemented for the various groups of transactions to fulfil the requirements of MAR.

The prohibition of market manipulation applies to all affected companies in the markets concerned in addition to other obligations to disclose insider information. Suitable processes must be put in place for monitoring and preventing market manipulation and the public disclosure of inside information.

The reality in practice is somewhat mixed in our experience. While measures have already been implemented and guidelines have become effective in many companies, others are still discussing whether they are affected and analysing the extent of necessary adjustments. However, there is clarity already about the obligation to maintain insider lists on internal and external individuals with access to inside information, and also on training staff who trade in financial markets. Larger discussions relate to the following issues:

- What instruments and markets are actually affected (e.g. commercial papers, physical commodity trading with effects on derivative settlements through Platts, Heren, etc.)?
- How can the exercise, attempt or inducement, and taking advantage of market manipulation be prevented?
- Are there particular strategies, such as algorithmic trading or the deliberate placement and withdrawal of limit orders, and how can these be monitored and documented?
- What additional requirements for REMIT trades, i.e. wholesale electricity and natural gas products, arise from the rigorous interpretation and application of MAD II/MAR?

These open questions will have to be addressed in the coming months in the Q&As of ESMA and their interpretations.

## **Update of MiFID II**

Companies trading derivatives on commodities or energy on a large scale have been waiting for the revised Regulatory Technical Standards (RTS) for the Markets in Financial Instruments Directive (MiFID II) for a long time to be better able to decide whether they might be classified as an investment firm or are subject to limitations with regard to the volume of hedging transactions on commodity futures exchanges. On 1 December 2016, the European Commission submitted regulatory technical standards on criteria for establishing when an activity is to be considered to be ancillary to the main business (RTS 20; i.e. for determining size criteria for classification as a financial counterparty) and regulatory technical standards for

the application of position limits (RTS 21). This creates greater clarity, however the requirement of annual verification and application for an exemption remains.

The two documents are subject to a review period of three months by the European Parliament and the Council of the European Union (until 1 March 2017). The date of full application of MiFID II will be 3 January 2018. By that date, all companies should identify the extent to which they are affected and complete the related implementation measures. The objective of most companies is to avoid obtaining a MiFID licence and the associated obligations for compliance with banking regulatory requirements. A number of requirements must be fulfilled.

Non-financial institutions, for example, do not need to obtain a MiFID licence, if their use of commodity derivatives and emission certificates/derivatives in trading is ancillary to their main business. This will be the course of action for most companies in an effort to prove that they are not affected. Position limits for trading in regulated markets must also be observed.

There are two approved methods to demonstrate that trading in commodity derivatives is only ancillary to the company's main business, both of which consist of a two-stage test:

- A 'main business test' can be conducted by determining the ratio of derivatives not intended for mitigating risk to the total volume of derivatives. Depending on this ratio, the volume of derivatives traded by the group within the EU may not exceed certain percentages of the total volume of derivatives traded in a particular type of commodity.
- The 'capital employed test' can be used to determine the ratio of capital allocated to derivatives trading (pursuant to the Capital Requirements Regulation - CRR) to non-current capital (assets less current liabilities). This ratio, in turn, also determines the relevant threshold for the percentage of derivatives traded in the EU derivatives market in a particular type of commodity.

Some detailed questions must be resolved in the course of implementation, such as the possibility of netting positions of subsidiaries and at group level, calculating the volume of options based on delta equivalents, the creation of separate open positions for spot and other months, or determining the annual average 'deliverable supply' of a commodity.

Moreover, in these projects, operational realisation of the implementation and application process as well as design of IT should not be underestimated for efficient regular measurement, especially in heterogeneous corporate and IT structures.

#### **REMIT – health-check lessons learned**

Together with the Market Abuse Directive for financial markets (2003), the REMIT (Regulation on Wholesale Energy Market Integrity and Transparency), which took effect in 2013, is intended to prevent market abuse in the wholesale energy market. It has been a requirement already for about a year, pursuant to the Council Implementing Regulation (EU) of REMIT, to report transactions in the wholesale energy market for the supply of electricity or natural gas to the European Agency for the Cooperation of Energy Regulators (ACER). A good time therefore to take stock of the degree of implementation at the companies concerned. Of particular interest in this regard are experiences and challenges which have equally affected all companies.

One of these challenges relates to identifying a company and possibly also some of its facilities as market participants as defined by REMIT and the associated consequences in terms of whether the company or facility must be reported or not. Originally, the Council Implementing Regulation (EU) provided that only companies or facilities are included in analysis with the technical capability to consume 600 GWh/year or more electricity or natural gas. The challenge was that the view of the German Federal Network Agency [BNetzA] then changed somewhat during the implementation phase: the threshold is no longer to be considered from the perspective of individual facilities of a company, but the 'economic entity'. Through

reinterpretation of the regulation, companies which initially were not within the scope of application of the Council Implementing Regulation (EU) could become the focus of REMIT.

Once all market participants within a company have been identified and IT for reporting has been implemented, it would be advisable to test the reporting-IT in a test environment for reliability before going live. Such tests are indispensable especially when the reporting solution is offered as a service for contracting partners or third parties. Negative tests are highly informative with regard to the reliability of the implemented solution, i.e. tests with deliberately incorporated errors or inconsistencies to determine whether the reporting software identifies such errors. However, negative tests are more elaborate to design, implement and analyse, so that they were often neglected by market participants in the past and now have to be undergone retroactively with a lot of effort.

It has been our experience in practice that reporting entails a completely new, relatively unknown overall process that frequently requires manual intervention, in which both the front and back office as well as Compliance are involved. Staff involved in this process require extensive descriptions, procedural instructions, guidelines and, not least, training to be able to meet their responsibilities. Therefore, it is indispensable to make these documents available with the necessary due diligence and detail and to also update them at regular intervals.