



– Position Paper –

Implementation of the MiFID II ‘Liquidity provider obligation’ for trading venues

Brussels, 8 June 2016 | **Introduction - Privileged Transactions**

MiFID II allows non-financial firms active in commodity derivatives markets to be exempted from the requirement to obtain a MiFID license if they satisfy certain conditions, including remaining below certain ancillary activity thresholds. The rationale of the ancillary activity tests is to check whether entities not subject to financial regulation should be required to acquire an authorisation due to the relative or absolute size of their activity in commodity derivatives, emission allowances and derivatives thereof.

Article 2(4) of MiFID II permits a number of transaction types to be classified as “privileged transactions” and thus to be set aside for the purposes of the ancillary activities calculations. Those transaction types include *“transactions in commodity derivatives and emission allowances entered into to fulfil obligations to provide liquidity on a trading venue, where such obligations are required by regulatory authorities in accordance with Union law or with national laws, regulations and administrative provisions, or by trading venues”*.

This, in turn, raises a practical question about which specific types of transaction should be classified as privileged transactions for these purposes. Whilst ESMA has not, thus far, addressed that question in a comprehensive manner, it has given an example of the circumstances in which transactions undertaken in order to fulfil liquidity obligations would be privileged. i.e.:

- The market making requirements established by the UK energy regulator, OFGEM, which oblige large electricity suppliers to post the prices at which they buy and sell wholesale electricity on power trading platforms up to two years in advance and to trade at those prices.

In contrast, ESMA has stated that privileged transactions should not include transactions undertaken by a firm to fulfil obligations to provide liquidity into the market following receipt of instructions from a trading venue as part of its position management process, as outlined by Article 57 (8)(d) of MiFID II. ESMA took that stance on the ground that such obligations only apply on a temporary basis. The corollary is that obligations to provide liquidity on a trading venue on an ongoing basis should be treated as privileged transactions – provided, of course, the main business of the entity fulfilling those obligations is not market-making (consistent with MiFID II, Article 2(1)(j)).

It is our understanding that there is a preliminary agreement amongst NCAs that transactions carried out under liquidity programmes can be excluded from the ancillary activity calculations under certain conditions, i.e. they may qualify as privileged transactions.

Europex fully supports this understanding and would welcome the development of more detailed level 3 guidance documentation by ESMA, which would provide for a common understanding on how the liquidity provider obligation can be implemented in practice, thereby contributing to the harmonised application of the ancillary activity calculations and mutual recognition of approved liquidity programmes.

Interpretation of the requirements

Considering the above depicted regulatory framework, Europex would welcome Level 3 guidance which would contain the following clarifications regarding the requirements for the 'liquidity provision' category of 'privileged transactions':

- (i) The obligation to provide liquidity under Article 2(4)(c) has to be imposed by either regulatory authorities or MiFID II regulated trading venues.
- (ii) A trading venue may introduce the obligation to provide liquidity on participants through liquidity programmes, by virtue of which the traded volumes would be subject to potential exclusion as detailed in Article 2(4)(c).
- (iii) The primary requirement for such traded volume to qualify for the exclusion is that the liquidity programmes needs to contain a firm obligation imposed by the trading venue on the participating firms to enter into commodity derivatives transactions on the venue. The obligation furthermore needs to be specified by the venue as to what that obligation is and may arise from the rules and regulations of the trading venue and/or a contractual agreement between the venue and the participant.
- (iv) The liquidity programmes must be transparent, fair and non-discriminatory and should not create incentives which would give rise to disorderly trading conditions or market abuse (as set out under Article 48(3)).
- (v) It is only the transactions carried out under the liquidity provider or market making programme that are to be set aside for the purposes of the ancillary activities calculations - not the participant acting as the liquidity provider/market maker as a person.
- (vi) Generally, two types of liquidity programmes can be distinguished which would be in scope of the exclusion:
 - (a) "**Market Maker Programmes**" – these are programmes for entities who meet the definition of "market maker" under Article 4(1)(7) including the requirement that they hold themselves out on a "continuous basis" as being willing to deal on own account by buying and selling financial instruments. Such programmes may have participants who are investment firms to which the so called MiFID II Market Making obligations under Article 17(3) of MiFID II and Draft RTS 8 apply, and/or participants who are not investment firms and who would fall under the exemption from the application of MiFID II as set out in Article 2(1)(j), provided that they are unregulated and meet the other conditions of the exemption in respect of commodity derivatives.
 - (b) "**Liquidity Provider Programmes**" – these are programmes where the participants do not hold themselves out as being willing to buy and sell on a "continuous basis". However, they are nonetheless a valuable source of

liquidity for other users of the trading venue. Analogous to the situation with market makers, the participants in liquidity provider programmes could be either firms whose sole business is the provision of liquidity in derivatives markets or firms which perform a liquidity provision function as an adjunct to their main business in physical commodity markets, i.e. they are engaged in the business of extracting, producing, generating, processing, storing, buying or selling the underlying commodity.

- (vii) In relation to Liquidity Programmes, there is nothing in MiFID II or Regulation (EU) No 600/2014 ("**MiFIR**") stipulating the existence, scale, nature of the incentive. In practice, the Liquidity Programme could be nominal, capped, tiered or subscription based.
- (viii) The exclusion from the calculation of ancillary activities as detailed in Article 2(4)(c) is available for non-financial firms participating in Market Maker Programmes and Liquidity Programmes in relation to all commodity derivatives.

We understand that there is a concern that the proposed construct could allow for companies to unrightfully make use of the exemption.

The following two-stage test fully excludes such a potential misuse of the exemption:

- The first stage would be to assess whether the transactions concerned had been undertaken in order to comply with identifiable liquidity provision obligations administered by a MiFID trading venue.
- The second stage would be to assess whether those transactions had been undertaken by a group which:
 - a. is engaged in the physical business of extracting, producing, generating, processing, storing, buying or selling the underlying commodity, as evidenced by its Annual Report and Accounts; or
 - b. otherwise demonstrates the ancillary nature of its liquidity provision.

Transactions would only be regarded as privileged if both the first and second stage tests were met.

About

Europex is a not-for-profit association of European energy exchanges with currently 26 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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