



Association of European Energy Exchanges

- Position paper -

## The MiFIR pre-trade transparency regime: making it work for commodity derivatives

Brussels, 25 April 2018 | The purpose of the present paper is to provide ESMA and all interested National Competent Authorities (NCAs) with detailed information in support of their work in amending specific aspects of 'RTS 2'<sup>1</sup> in relation to the MiFIR pre-trade transparency regime for non-equity instruments.

Europex members have long argued that the MiFIR pre-trade transparency regime does not apply to trade registration<sup>2</sup>. We consider that the regime in its present form is not fit for purpose and cannot be applied to trade registration facilities in energy derivatives markets without compromising their vital role in supporting the hedging activity of commercial market participants and in mitigating wider systemic risks.

We therefore welcome the view by ESMA and the NCAs that more clarity is needed. This should include active changes to RTS 2, to fix the current inapplicability of pre-trade transparency requirements to reported trades.

In the present paper we would like to highlight that the proposed Large in Scale waiver and the Illiquid markets waiver do not fit all non-equity markets, and particularly not the energy derivative markets.

In this context, we have positively noted that ESMA and the NCAs recognise that non-equity markets are fundamentally different from equity markets and that there are significant differences across the underlying non-equity markets themselves. This is *inter alia* reflected in differences such as how market participants use non-equity derivatives instruments for hedging and commercial purposes.

### 1) Background

The Markets in Financial Instruments Regulation ("MiFIR"), applying since 3 January 2018, has introduced a harmonised pre-trade transparency regime for certain financial instruments traded on a trading venue, including derivatives. According to MiFIR Art. 8, trading venues shall publish information about current bid and offer prices and the depth of trading interests at those prices advertised through their systems.

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<sup>1</sup> RTS 2 refers to the 'Commission Delegated Regulation (EU) 2017/583 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives', OJ L 87, 31 March 2017, p. 229–349.

<sup>2</sup> See attached letter from Europex Chairman Pieter Schuurs to ESMA Chair Steven Maijor.

Art. 8 rightly recognises that certain exemptions from the general requirement to publish pre-trade transparency data are necessary to preserve an orderly price discovery process and to allow nascent and niche markets to develop.

These exemptions are implemented through pre-trade transparency waivers for transactions above a certain volume threshold (Large in Scale waiver or 'LIS') and transactions in certain instruments which are classified as illiquid, regardless of their volumes (Illiquid Instrument waiver or 'IL').

RTS 2 sets out the methodology for calculating LIS thresholds and determining illiquid instruments. The LIS calculation is based on a threshold floor expressed as notional trade value in a given sub-asset class and the trade size which lies below the percentage of transactions corresponding to the trade percentile specified in the RTS for this sub-asset class. The IL thresholds are determined on the basis of the average traded daily notional amount (or average daily amount in case of emission markets) and the average daily number of trades as specified by the RTS for a given sub-asset class.

However, this methodology has proven unworkable in practice, in particular with respect to energy commodity derivatives. Calculations based on insufficiently granular sub-asset classes, besides arbitrarily selected and inappropriately calibrated parameters, result in disproportionately low LIS thresholds for highly liquid products and overly high thresholds for developing markets.

Trading venues and market participants are also challenged by the fact that the LIS thresholds are set in Euros instead of lots. Using lots has been the standard in the market for similar threshold calculations pre-MiFIR. The circumstance that the LIS thresholds are currently based on historical Euro trade values and not the number of traded lots in a particular sub-asset class can create unintended and disproportionate LIS thresholds that ignore the actual underlying trading behaviour.

For example, the LIS threshold for highly-liquid ICE Futures Europe Gasoil Futures calculated under the current RTS 2 methodology is equal to 10 lots compared to the 100 lots minimum block threshold previously applied before the introduction of MiFIR. In contrast, in far less liquid products such as Rotterdam Coal Options, only trades above 50 lots would be considered LIS as compared to the 5 lots block threshold pre-MiFIR.

Furthermore, the new methodology has led to a significant number of niche and nascent products being incorrectly (re-)classified as liquid, and thus becoming subject to significantly broader transparency requirements, which were previously reserved for developed markets.

The current market practice in the electricity market with broker systems is such that energy brokers offer clients clearing of exchange traded blocks at multiple venues. The trades are concluded outside the market but according to market rules. These blocks represent a large part of the total traded and cleared market (for the Nordic power markets it is approximately 50%). For example, the LIS threshold for a liquid Nordic power monthly contract is estimated to be 26 lots compared to an average order book lot of 5.4 (trade value = EUR 142,000) and 13 (EUR 263,000) lots for blocks. Too high LIS thresholds may lead market participants to revert to more bilateral trading (e.g. OTC and origination) outside transparent and supervised venues and outside CCP clearing. This increases market concentration and leads to less competition and ultimately lowers the social welfare gains of an efficient price discovery. Such a development clearly contradicts the G20 objectives to create more transparent and resilient derivative markets.

Hence, the applicability of MiFIR Art. 8 to reported trades and the ability of market participants to continue making use of trade registration facilities for their hedging and risk management activities are two related and very serious issues.

If implemented in its current form, the MiFIR pre-trade transparency regime would have a materially adverse impact on energy derivatives markets by:

- Preventing pre-negotiated trades to be submitted to exchanges, thereby limiting the ability of market participants to hedge their commercial exposures;
- Forcing the trading activity to move away to the OTC space, thereby limiting transparency and undermining the price discovery process as well as limiting the possibility of physical delivery to take place under the exchange rules;
- Limiting the number of cleared trades and therefore increasing systemic risk and market concentration;
- Preventing nascent commodity derivatives markets from developing;
- Pushing small and medium sized members towards more bilateral (OTC) trading, ultimately resulting in more direct trading with the large(r) producers, often referred to as origination business.

## **2) The rationale of exchange-operated trade registration facilities**

As a general principle, Europex members believe that financial markets are best served by a high degree of transparency in a multilateral environment. This approach maximises market participation and enables the matching of buying and selling interests in a manner which is conducive to forming competitive prices.

At the same time, and in respect of the derivatives markets operated by energy exchanges, there is a need for a calibrated approach to transparency in recognition of the fact that some forms of trading activity cannot easily be accommodated in a fully transparent central order book environment. If pre-trade transparency rules were to be applied to trade registration, the thresholds should at least be set in such a way as to encourage as much trading volume as possible to be executed through the central order book, taking into account a realistic assessment of the characteristics of the market and the liquidity in this order book.

Registered trades, and their accompanying rules and procedures, should be designed to support and complement orderly markets.

Typically, a market is suitable for the introduction of trade registration where it:

- (i) Offers a way to wholesale market participants in which to create or extinguish substantial positions without introducing disruptively large orders into the central order book. The use of an exchange's trade registration facility in those circumstances enables such participants to avoid an execution delay and/or a price slippage by executing large orders outside the central order book. Such business is executed under the exchange's rules and is subject to specific minimum volume thresholds as well as strict pricing parameters which are designed to ensure that registered trades are concluded at a fair market value;

- (ii) Supports the development of new or nascent on-exchange markets by providing an alternative to OTC trading. This creates a pool of open interest to support the transition of further trading from an OTC environment to an exchange environment;
- (iii) Enables market participants to pre-negotiate substantial trades against markets or settlements that would otherwise have to be traded directly in the relevant period, with the associated commercial and compliance risks.

### 3) Proposed solutions

#### ***Option 1: replacing the current RTS 2 methodology with a product-specific approach***

Energy exchanges have extensive experience in operating trade registration facilities and have developed sophisticated policies and carefully calibrated thresholds in this regard.

We therefore suggest that the amended RTS 2 should build upon these well-established practices. The current methodology for setting LIS thresholds should be replaced by a more appropriately tailored and market-based approach. Specific thresholds should be set by NCAs in cooperation with trading venues as regards instruments the venues admit to trading.

As to ensure a level playing field, ESMA and the concerned NCAs should consult their decisions when setting thresholds for products which have the same underlying but are traded on different trading venues.

The proposed approach to determining thresholds and rules for registered trades, as applied by trading venues pre-MiFIR, depends mainly on:

- The current liquidity in the contract;
- The commercial activity that underpins trading in the central order book (as the average lot size or the most frequently traded lot size).

For example, in the case of a highly liquid instrument, such as the Brent Futures contract, whilst approximately 600,000 to 900,000 lots are traded each day, the average trade size is only 2.4 lots and the number of lots at the best bid or offer is typically 30 or 40 lots. This means that an order of e.g. 1,000 lots is too large to be placed into the central order book since it would have a significant price effect, whether it is executed or not.

Brent, moreover, is a future contract used to hedge entire cargoes of oil in sizes of 600 lots or more. There is substantial appetite for such large trades. The size of a block trade permitted in liquid contracts is thus driven by what size of order would disrupt the central order book and by whether the underlying physical trade would be likely to give rise to orders of such size.

In less liquid and illiquid contracts, it is probable that the market will even have difficulties in absorbing orders of a modest size. A more nuanced approach is therefore needed. Typically, an exchange would consider which size of an underlying physical trade might require a futures hedge. For example, fuel oil contracts are not liquid in the central order book, but fuel oil itself is typically traded in tranches of 5,000 to 10,000 tonnes in the physical market. To enable a futures hedge to be executed on-exchange, the permitted block trade size should be equivalent, i.e. 5 lots. This adds to the open interest in the exchange contract, some of which is subsequently extinguished in the central order book, which

means that there is enough activity in the instrument for other market participants to offer or bid on-screen.

In addition, many contracts are traded as bundles – for example:

- (i) An option may trade bundled with an underlying future contract as a delta hedge;
- (ii) A margin strategy will involve buying crude and selling gas oil, jet, and naphtha against it;
- (iii) A seasonal hedge may involve buying all six months of the summer and selling all six months of the winter;
- (iv) In the Nordic power market, a full hedge of the bidding zone will consist of a liquid system contract and an illiquid classified Electricity Price Area Differential (EPAD) contract.

In these cases, exchanges consider all the components to be a single reported trade, as they share a common economic purpose, and thus allow the size of each component to be added in order to meet the threshold.

***Option II: re-calibrating the LIS and IL parameters for energy commodity derivatives***

We believe that acknowledging the long-standing and well-established practice of setting minimum thresholds for registered trades and determining liquid markets through exchanges would be the most appropriate way of revising RTS 2. However, we would also welcome a less comprehensive amendment in the meantime in order to ensure a timely implementation of the MiFIR pre-trade transparency regime.

As mentioned above, the overly restrictive thresholds and improper classification of niche and nascent markets as liquid result *inter alia* from the inaccurately set parameters for LIS and IL waivers. We therefore propose that these parameters are recalibrated in order to better reflect the actual markets.

We will provide ESMA and the NCAs with specific recommendations for such a recalibration in a separate document. The intention is to allow the pre-trade transparency regime to be implemented based on the current methodology but without putting orderly markets at risk.

## **About**

Europex is a not-for-profit association of European energy exchanges with 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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