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MANAGING UNCERTAINTY

The recent agreement between EU institutions on a second wave of Mifid legislation will only increase the current level of uncertainty shaking the commodity market. Amid this backdrop, participants need to reconsider their coping strategies, argues **Steffen Köhler**

The issue of regulatory uncertainty is an omnipresent factor in today's commodity markets. It is a fundamental consideration in the decisions we make on a day-to-day basis and has a significant impact on how we plan for the future. Following the financial crisis of 2007 and 2008, a bundle of new European regulatory initiatives have been finalised and many have

already taken effect. This affects the future of the energy trading environment in the European Union, with numerous practical and strategic consequences for market participants.

Two prominent examples of this are the Regulation on Wholesale Energy Market Integrity and Transparency and the European Market Infrastructure Regulation (Emir). Neither of these has been

fully implemented yet, but they have already changed many important aspects of how energy trading works in the EU. Most recently, the European Parliament and the Council of the EU finally agreed and adopted a common text on a new Markets in Financial Instruments Directive, along with an accompanying Markets in Financial Instruments Regulation – together known as 'Mifid II'.

Top: Brian A. Jackson / Shutterstock.com

“ *Given that the devil is often in the detail, many important questions relating to Mifid II’s practical application remain open* ”

A significant number of additional delegated acts, regulatory technical standards and other secondary legislation has to be drafted and adopted by the Paris-based European Securities and Markets Authority (Esma) and the European Commission before the new legislation can take full effect. In addition, the Mifid II directive must be transposed into national law by all 28 member states, a process that is supposed to take another two years. Hence, Mifid II is only likely to be fully applied by 2017.

Given that the devil is often in the detail, many important questions relating to Mifid II’s practical application remain open for the time being. The long and complex implementation process presents an increased level of uncertainty and will continue to do so for years to come. During this time, market participants must factor increased regulatory risk into their business decisions. And as with all kinds of business risk, the risk management techniques used by market players – including risk mitigation and hedging principles – will have to be adapted accordingly.

For example, it is unclear how wholesale commodity derivatives transactions will be classified in the context of the different pieces of financial regulation, particularly those that are important to hedging or proprietary portfolios. In this context, the exact definitions of different types of multilateral trading venues require special attention. Alongside regulated markets (RMs) and multilateral trading facilities (MTFs), Mifid II introduces a ‘third category’ of trading venues, known as organised trading facilities (OTFs). One important aspect of this is how the use of discretion in matching trades

acts as the main distinguishing feature between RMs and MTFs, on one side, and OTFs on the other. This ensures a clear differentiation between the individual platforms and provides some regulatory certainty.

Crucially, a new definition of financial instruments needs to be further specified. This is particularly true when it comes to contracts linked to electricity and natural gas. Moreover, the size and nature of exemptions for commodity firms in Article 2 of Mifid II, which help determine whether a firm has to comply with Mifid or not, need distinct and unambiguous rules to enable a harmonised and equal application across the EU.

Against this backdrop, if I were to put myself in the shoes of a market participant, I would think about the best and easiest way to tackle this situation. For instance, what would I do if changes in the regulatory interpretation of different transactions affected my portfolio? Of course, the answers to these complex questions will have to be given by each market participant individually. And as always, there are more and less risk-averse approaches. However, the necessity to face this new situation and to make sound decisions cannot ultimately be avoided, especially with regard to non-hedging activities.

Clearly, I do not think that there is any reason for market participants to panic or to fundamentally change the way they trade and hedge. However, market players should consider these regulatory risks carefully and mitigate ‘exposures’ – for example, on proprietary portfolios – by trading via an RM. By doing so, they stay within the ‘safe haven’ these venues provide through well-established and comprehensively



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regulated infrastructure and processes. Such a route offers certainty about the regulatory classification and treatment of their transactions.

The implementation process of Mifid II is a long one and the answers to all these questions are unlikely to come quickly. The new legislation will obviously affect all companies operating in the EU financial services market, including energy exchanges. So as you can imagine, myself and my colleagues are following the political and regulatory discussions on Mifid II very closely and with great interest. Looking ahead, I personally believe that the spirit of the globally accepted Group of 20 commitments from Pittsburgh in 2009 will also drive the implementation process and the definition of technical details. Hence, I am convinced that regulated venues and clearing houses will retain and further strengthen the important role they play – both in the commodity markets generally, and in energy trading in particular. ■