MiFID II: how will it impact participants in the EU ETS?

Background on MiFID

Since 2007, a European-wide legislation (**Markets in Financial Instruments Directive,** MiFID) has been put in place that spells out the rules for investment services and activities in financial markets. A revision of those rules was recently adopted and published in April 2014 This new Directive/Regulation will enter into force at the start of 2017 – it is known as **MiFID II**.

MiFID II extends the original scope to cover all derivative and spot contacts for commodities, including **EU ETS emission allowances**. The vast majority of transactions in the EU ETS are derivative instruments, with the remainder being spot contracts. By covering both product classes, and by classifying emission allowances as financial instruments, MiFID II affects the trade in such EU allowances. It therefore potentially covers banks, traders and brokers trading in emission allowances, and more specifically in EUAs, EUAAs, CERs and ERUs. However, **exemptions apply with a view to exempting those who trade EU spot allowances for compliance with their EU ETS obligations**.

Shortly after MiFID II was adopted, the European Commission (EC) mandated ESMA (European Securities and Markets Authority) to provide technical advice on delegated and implementing acts. Many of the provisions outlined in MiFID II will therefore be implemented by means of technical standards drafted by ESMA and approved by the EC and the European co-legislators.

Delegated and technical acts referred to in the MiFID II legislation will be transposed by Member States by the second quarter of 2016 and will apply from 3 January 2017 onwards.

On 28 September 2015 ESMA published its final proposal for Regulatory and Implementing Technical Standards for MiFID II/MiFIR.

This briefing outlines the main characteristics of MiFID II (the basic legislation), as well as ESMA's proposed standards for implementation the legislation, that will have a direct impact on firms involved in trading of emission allowances under the EU ETS.

Exemptions

The proposed standards by ESMA would potentially see many companies involved in trading emission allowances, including small and medium-sized utilities, falling under the scope of MiFID II. Such firms would be required to buy a MiFID licence and to hold large capital reserves. However, the objective of this revised legislation was not to affect spot trading activities carried out by firms for compliance purposes with the EU ETS (see Article 2(e) of the legislation). MiFID II furthermore foresees exemptions for non-financial companies trading in commodity derivatives on an ancillary basis to their main commercial group business. ESMA's proposed standards include thresholds for determining such exemptions stated in the legislation.

Dealing on own account exemption: firms that do not provide investment services other than dealing on own account are exempt. This exemption does not apply to dealing on own account in emission allowances, which is covered by the other exemptions.

Operators with compliance obligations under the EU ETS Directive dealing in the spot market only: MiFID II does not apply to operators with compliance obligations under the EU ETS if they deal in the spot market only, unless they:

- make use of high frequency algorithmic trading techniques,
- provide investment services or perform investment activities other than dealing on own accounts, or
- execute client orders.

Ancillary activity exemption: Two types of firms can benefit from this exemption:

i. Firms dealing on own account, including market makers, in commodity derivatives or emission allowances or derivatives thereof, excluding persons who deal on own account when executing client orders; or
ii. Firms providing investment services, other than dealing on own account, in commodity derivatives or emission allowances or derivatives thereof to the customers or suppliers of their main business;

This exemption applies to both the spot and derivatives trading. This exemption does not apply in case operators make use of high frequency algorithmic trading techniques.

The 'ancillary activity exemption' requires that a firm falls below the thresholds for both the following tests if it is to be exempt from the scope of MiFID II:

1. **Market Share Test**: the threshold for emission allowance is set at 20%, meaning that a firm falls below he threshold if its speculative trading activity is less than 20% of the overall EU carbon market activity. Hedging transactions are not taken into account for this test, when calculating a firm's speculative trading activity*.
2. **Main Business Test:** it measures a firm's speculative trading in commodity derivatives as a percentage of

* For 'hedging', ESMA proposes to use the same definition set out in article 10 of the OTC Derivative Technical Standard for EMIR (here)

its total commodity derivatives trading:

- If speculative trading is less than 10% of total trading, the activity is considered ancillary and the firm is exempt, provided that also the Market Share Test threshold is met;
- If a firm's speculative trading is 10-50% of its total trading, it can be MiFID exempt if its market share is less than 50% of each threshold in the market share test (i.e. less than 10% for EUA trading);
- If a firm's speculative trading is above 50% of its total trading, it may be exempt if its market share is less than 20% of each threshold in the market share test (i.e. less than 4% for EUA trading).

Optional Exemption by Member States

Member states can exempt firms providing investment services in emission allowances and their derivatives for the sole purpose of hedging the commercial risk of operators of installations with compliance obligations under the ETS Directive, provided in each case that these clients jointly hold 100% of the capital or of the voting rights of such firms, exercise joint control and would be exempt under the ancillary activity exemption if they carried out the investment services themselves. Any firm benefitting from this optional exemption must be subject to similar Member State requirements.

A firm meeting the exemption requirements for its trading in emission allowance might still be captured under the scope of MiFID II for its trading activities in other commodities. Therefore, the aforementioned tests should be carried out for all commodity classes. Firms are required to comply with the regulation for all commodity classes even if the thresholds are exceeded for only one commodity class. Brokers and professional traders are likely not to be entitled to benefit from exemptions. Trading venues need to obtain a MiFID authorisation.

Data for the Exemption Tests

ESMA proposes to use rolling average of data over the last 3 years in the calculation for the exemption tests. An interim period applies for the first years, before the start of the rolling average system. In the interim period, the data relies on the period from from 1 July 2015 to 30 June 2016, i.e. before the standards have actually been adopted, to initially decide whether firms are exempt or not from the scope of MiFID II. This has the undesirable effect of preventing firms to adapt their trading strategies in advance of such an adoption.

Position Limits

Member States regulators are mandated to set limits on the size of a net position that a person can hold at all times in commodity derivatives traded on trading venues as well as economically equivalent OTC contracts. Limits do no apply to positions held by or on behalf or non-financial entities for hedging purposes. Position Limits do not apply to trading in emission allowances.

Position Reporting

Trading venues are required to publish weekly reports covering aggregate positions in commodity derivatives or emission allowances or derivatives thereof. Reports should detail the aggregate position held by the different categories of persons. These reports need to include the number of long and short positions by category, changes from the previous report and other details.

Investment firms and market operators trading outside a trading venue must provide to the competent authority a daily breakdown of positions held by all persons. Position reporting applies to trading in emission allowances. Firms falling under the exemptions are nevertheless covered by provisions on position reporting. Reports must also distinguish between hedging transactions and other positions.

Liquidity Assessment for Derivatives and Emission Allowances

A yearly liquidity assessment is now required under MiFID II, which is aimed at providing regular and greater transparency in the non-equities markets. Liquidity will therefore be calculated annually, using average daily notional amount and average daily number of trades, and measured against set thresholds.

MiFID Compliance

Firms that cannot benefit from one of the exemptions listed above will be captured under the scope of MiFID II. This means that they will need a MiFID license to be able to undertake trading activities, with the associated implementation costs, they will have to comply with stricter rules on capital and transparency requirements.

Next Steps

The Commission now has three months (before the end of 2015) to adopt, amend or reject the technical standards proposed by ESMA. After the Commission's approval, the standards will need to be rubberstamped by the European Parliament and Council. MiFID II will apply from January 2017.

CONTACT INFORMATION

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