Deutsches Aktieninstitut

Specifics of hedging derivatives should be considered carefully

Amending MiFID II and MiFIR should not negatively impact corporate risk management

Comment on the proposal of the European Commission amending MiFID II and MiFIR, 24 February 2022

Introduction

The revision of MiFID II and MiFIR proposed by the European Commission in November 2021 touches the transparency regime. Although we very much appreciate market transparency as an important tool to reach an appropriate level of investor protection, we would like to highlight some negative impacts of transparency in particular for derivatives used by non-financial companies for hedging purposes.

After some general remarks concerning the specifics of these instruments we would like to draw the attention of the legislator on negative impacts associated with the proposed changes in the transparency regime for non-equity instruments, especially for corporate end-customers. Furthermore, we would like to stress that the OTC-platforms non-financial clients use today should not be affected by the transfer of the definition "multilateral trading" from MiFID to MiFIR.

Noteworthy, the particularities of hedging derivatives used by non-financial companies are already acknowledged by the legislator. Hence, derivative transactions that are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity are exempted from the pre-trade transparency requirements according to Art. 8(1) MiFIR.

Deutsches Aktieninstitut suggests:

1. To provide coherence the legislator should insert a general exemption from the pre- and post-trade transparency regime for corporate hedging derivatives. At a minimum, exemptions given should not be limited to certain trading channels (e.g. waivers valid for platforms, but not for Systemic Internaliser).

2. Legislator should clarify that existing OTC-platforms, which just facilitate the execution of bilateral derivative agreements, remain available for corporate end-users.

3. Legislator should remedy an obvious editorial error and re-insert an exemption for hedging derivatives in Art. 1(d)(ii) MiFID, which was introduced in 2016 by a quick fix. The current proposal refers to the text adopted in 2014, which is meanwhile obsolete.

1 Specifics of derivatives used for hedging purposes

The well-justified exemption mentioned above acknowledges that OTC derivatives used by non-financial companies for hedging purposes – including contracts executed on MTFs or OTFs – are different from securities and in particular from shares: bilateral OTC derivatives are not fully fungible and standardized transactions with secondary market trading; but are individually requested by customers when required for hedging purposes.

Like loan contracts, leasing contracts, saving account contracts etc. these derivative transactions are contracts bilaterally agreed between clients and banks. Trading of these “bespoke” derivatives in question on secondary markets does never take place - if they are no longer required, they are terminated.

There is also no third-party investor involved who should be protected. To be frank: No capital markets expert would seriously propose to introduce a transparency regime with the publication of price and volume data before or after the conclusion of loan or leasing contracts. Nevertheless, this is the regulatory reality as regards to bespoke derivatives.

On the contrary, especially for larger transactions or transactions referring to an illiquid underlying it is very likely that transparency distorts the price formation process to the detriment of the non-financial company. It is common market practice to split an order for larger and/or illiquid transactions up into smaller buckets, and orders executed at a later stage will usually become remarkably more expensive already in the current regime. The reason for this is that it is unlikely that various companies demand an identical transaction at the same time. The supply side can therefore conclude that the split orders can be attributed to the same end-user, and bet against him. It isn’t relevant who the end-user is – trading profits are made regardless. As a result, prices for the end-user will increase which makes risk management more expensive.

2 Problematic transparency issues proposed by the European Commission

Against this background we deem the following proposals tabled by the European Commission as problematic:

- The proposed revision of Art. 11 MiFIR curtails the existing maximum deferral periods for prices until the end of the trading day or the volume of transactions for two weeks. The revised deferral regime does not adequately reflect the specifics of derivatives used by non-financial customers as mentioned above. If these data have to be published too early, this will result in significant price increases of the derivative transactions concerned. Hedge funds speculating on these price increases will benefit; the non-financial customer must bear the damage.

- The same holds true for the proposed deletion of the “size specific to an instrument threshold” (SSTI) in Art. 11 MiFIR. Furthermore, it is not clear whether the pre-trade exemption for Systemic Internaliser according to Art. 18(10) MiFIR will be still valid, as it refers to Art. 9(5)(d), which is proposed to be deleted as well. While intended as a contribution to more client/client investor protection, the opposite effect would be the case. The deletion makes it harder for EU liquidity providers to provide competitive pricing for EU clients. While Systemic Internaliser are required by pre-trade-transparency to publish their quotes, the immediate (i.e. without any deferral) release of the price and the volume according to the post-trade-transparency would allow the market to conclude which Systemic Internaliser has executed a trade. This will expose Systemic Internaliser to “undue risk”, namely the risk that they themselves would be unable to hedge their risks, because the market will have clear sight of their risk exposures. Clients like corporate end-users will face higher prices or a shrinking supply of derivative instruments needed in their risk management.

3 Other remarks concerning OTC-platforms and the hedging exemption

Furthermore, the proposed insertion of the definition “multilateral trading” in MiFIR should reflect specifics of derivatives used by non-financial companies. So far, non-financial companies use platforms e.g. provided by 360T, which are not designated as multilateral, but as OTC trading.

Clients use these platforms in order to agree with banks on the details of a derivative contract bilaterally. Non-financial companies put a specific request in the system regarding quotes and other structural features concerning the derivative needed. The input is directed to the banks affiliated to the platform which are selected by the client for bilateral trading. Instead of phoning each bank subsequently, the client gets answers from many banks simultaneously. The information exchange on the platform takes place on a discretionary basis, e.g. the client choses to which bank his/her request is submitted and whether he/she enters into the transaction with the bank or not.

It is essential that these OTC-platforms remain designated as OTC even when the definition is transferred. First of all, these platforms shield non-financial companies using hedging derivatives from inappropriate transparency obligations. The derivatives in question are also not in the scope of the “trading on a trading venue” definition (this may change, as the definition is currently under scrutiny).

In addition, with trading on a multilateral platform according to the MiFID/MiFIR definition, in particular MTF or regulated market, non-financial companies run into the risk to be defined by regulation as an investment firm. The “trading on own account” exemption according to Art. 1(d)(ii) MiFID exempts market participants from the MiFID scope unless they execute their non-hedging transactions as members or participants in a regulated market or an MTF. The mere risk associated with the licence requirement makes non-financial companies refrain from choosing these platforms.

Finally, we would like to point out an editorial error. The above-mentioned exemption for hedging derivatives in Art. 1(d)(ii) MiFID was introduced in 2016 by a quick fix. The present proposal of the European Commission refers to the original MiFID version adopted in 2014. Therefore, the hedging exemption is missing in the proposal to revise Art. 1(d)(ii). This should be remedied by re-inserting the already existing hedging exemption.

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