

20 November 2015

InfoNet



MiFID II/R Seminar

Commodities

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|---------------|---|
| 08.30 - 09.00 | Registration |
| 09.00 - 09.30 | Presentation
Chris Borg, Partner, Reed Smith |
| 09.30 - 10.00 | Presentation
<i>Paul Willis, Technical Specialist - Commodities, FCA</i> |
| 10.00 – 10.30 | Q&A
<i>Questions from the floor</i> |

Chris Borg, Partner, Reed Smith

Infonet MIFID2/R Seminar

FIA Europe

20 November 2015

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MiFID2/R & Commodities – Overview

Key Items

- Expansion of Product Scope
- Position Limits/Position Reporting
- Transparency & Systematic Internalisers
- Ancillary Business Exemption
- ... and much more

“Day of the MiFID”



(7 Sep 2006)

MiFID2/R:Scope - Financial Instruments

ANNEX I, SECTION C

C(5): Cash-settled commodity derivatives

C(6): Physically-settled commodity derivatives on a RM, MTF or OTF

“...except for wholesale energy products traded on an OTF that must be physically settled”

C(7): Other physically-settled commodity derivatives

“...not being for commercial purposes and having the characteristics of other derivative financial instruments...”

C(10): Exotics Derivatives

“climatic variables, freight rates, inflation rates or other official economic statistics”

C(11): Emission allowances

ESMA FINAL REPORT (19 December 2014)

C(6)

- “Must be physically settled”: “wholesale energy products” OTF exception
- Scope of oil and coal transitional treatment under article 95

C(7)

- Definition of “*not being for commercial purposes and having the characteristics of other derivative financial instruments*”

Not addressed in Final Report

- OTF definition
- Treatment of booked-out/circled out markets

MiFID2/R: ESMA Final Report Dec 2014 - C(6)

“REMIT” EXEMPTION

- “Wholesale energy products”
- Traded on an “OTF”
- “Must be physically settled”

ESMA Technical Advice

- “Must be physically-settled”:
 - “Proportionate arrangements” for delivery
 - “*Obligations under the contracts cannot be offset against other contracts*” (apart from payment netting)
 - Operational netting (gross/net nominations)
 - “Force majeure”, “bona fide inability to settle”, “default”

OIL & COAL (TRANSITIONAL EMIR EXEMPTION)

- Exemption from EMIR clearing, risk mitigation and NFC+ threshold calculation treatment (July 2020 expiry)
 - NCAs to grant exemption (on a per contract basis)
 - Available only to NFC+s and firms which become MIFID authorised for the first time “as from 3 Jan 2017”
- **C(6) energy derivatives:** relate to oil or coal ; traded on OTF, and must be physically-settled
- **Oil:** “*contracts having mineral oil, of any description and petroleum gases, in liquid or vapour form, including products, components and derivatives of oil and oil transport fuels, including those with biofuels additives, as an underlying*”
- **Coal:** “*contracts with coal, defined as a black or dark brown combustible mineral substance consisting of carbonised vegetable matter, used as a fuel, as an underlying*”

MiFID2/R: ESMA FR Dec 2014 (contd) – C(7)

C(7): Physical forwards not under C(6)

- Not spot;
- Not for commercial purposes, and
- “have the characteristics of other derivative FIs”

ESMA Technical Advice:

- **Spot:**
 - 2 trading days, or
 - Period generally accepted in the market ... as the standard delivery period, and
 - No “understanding” that contract is to be rolled over.
- **Commercial purposes?**
 - Narrow category for energy balancing activity

ESMA Technical Advice : “Characteristics”

Standardisation Criterion

- Price, lot, delivery date or other parameters determined principally by reference to standardised prices, lot sizes, delivery dates;
AND

Trading Criterion

- Traded on a third country TV (similar to RM, MTF or OTF);
- Expressly stated to be traded on, or subject to rules of, a RM, MTF, OTF or third country TV;

OR

- ~~Expressly stated to be~~ equivalent to a contract traded on RM, MTF, OTF or third country TV (with regard to prices, lots, delivery dates)

MiFID2/R- Organised Trading Facilities

“Multilateral trading system which is not a regulated market or MTF and in which multiple third party buying and selling interests in bonds, structured finance product, emissions allowances or derivatives are able to interact in the system in a way which results in a contract”

- Voice brokers?
- Platts e-window?
- Broker aggregation systems?

Interpretation?

- “Multilateral”, discretionary and “within the system”
- Voice broking systems included in draft RTS2 on transparency regime...
- **Recitals (8) and (9)** suggest:
 - “broadly defined”
 - intended to capture “all types of organised execution and arranging of trading”
- **Excludes:**
 - bulletin boards,
 - compression & post-trade services
 - bilateral (single dealer platforms)

MiFID2/R: ESMA FR Sept 2015 - Position Limits

- **Net position**
- **Person**
- **Commodity derivatives on trading venues (CDTV)**
- **Economically equivalent OTC contracts (EEOTC)**

and ...

- **Aggregated basis**
- **Excluding hedging by non-financial entities**
- **One limit for CDTV's which are "same"**

"...position limits on the size of a net position which a person can hold at all times in commodity derivatives traded on trading venues and economically equivalent OTC contracts..."

MiFID2, art 57(1)



MiFID2/R: ESMA FR Sept 2015 - CDTV

“Commodity derivatives on trading venues”

- **“Trading venues”**: RMs, MTFs or OTFs
- **“Commodity Derivatives” include:**
 - Many physical forwards (subject to “REMIT” C6/C7 carve-out)
 - Derivatives on “exotics” (freight, emissions etc)
 - Securitised derivatives (certificate & warrant programmes)
- **So PLs do not apply to:**
 - Non-EEA venues
 - Spot physical
 - REMIT products carved out of C6/C7
 - ETCs/ETNs?



MiFID2/R: ESMA FR Sept 2015 - “Same” CDTV

Single position limit per contract per TV?

- Definition of “same”
 - Very narrow (“subset of economically equivalent”)
 - “... have identical contract specifications, terms and conditions, excluding post-trade risk management arrangements”; and
 - “... form a single fungible pool of open interest ... by which positions held in [one] on one TV may be closed out against positions held in [the other] on another TV”
 - Cash-settled and physical futures are **not** “the same”
- Potentially 1000s of separate limits on 3 Jan 2017...



MiFID2/R: ESMA FR Sept 2015 - EEOTC

“Economically equivalent OTC contracts”

- Excludes commercial physical holdings
- *Identical* contract specifications, terms and conditions, excluding post-trade risk management arrangements (to a CDTV)
- So some LME Lookalikes and what else....?

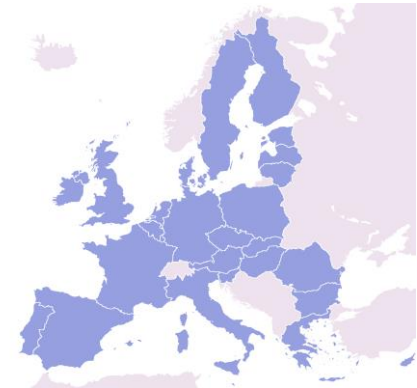


MiFID2/R: ESMA FR Sept 2015 – Person

Person

Territorial scope

- Intention to catch any “person” anywhere, but NB:
 - *“This Directive shall apply to investment firms, ...and third country firms providing investment services or performing investment activities through the establishment of a branch in the Union” (Art 1(1))*
 - *“[Position limits and position reporting] shall also apply to persons exempt under Article 2” (Art 1(6))*
- Down to Member State implementation.

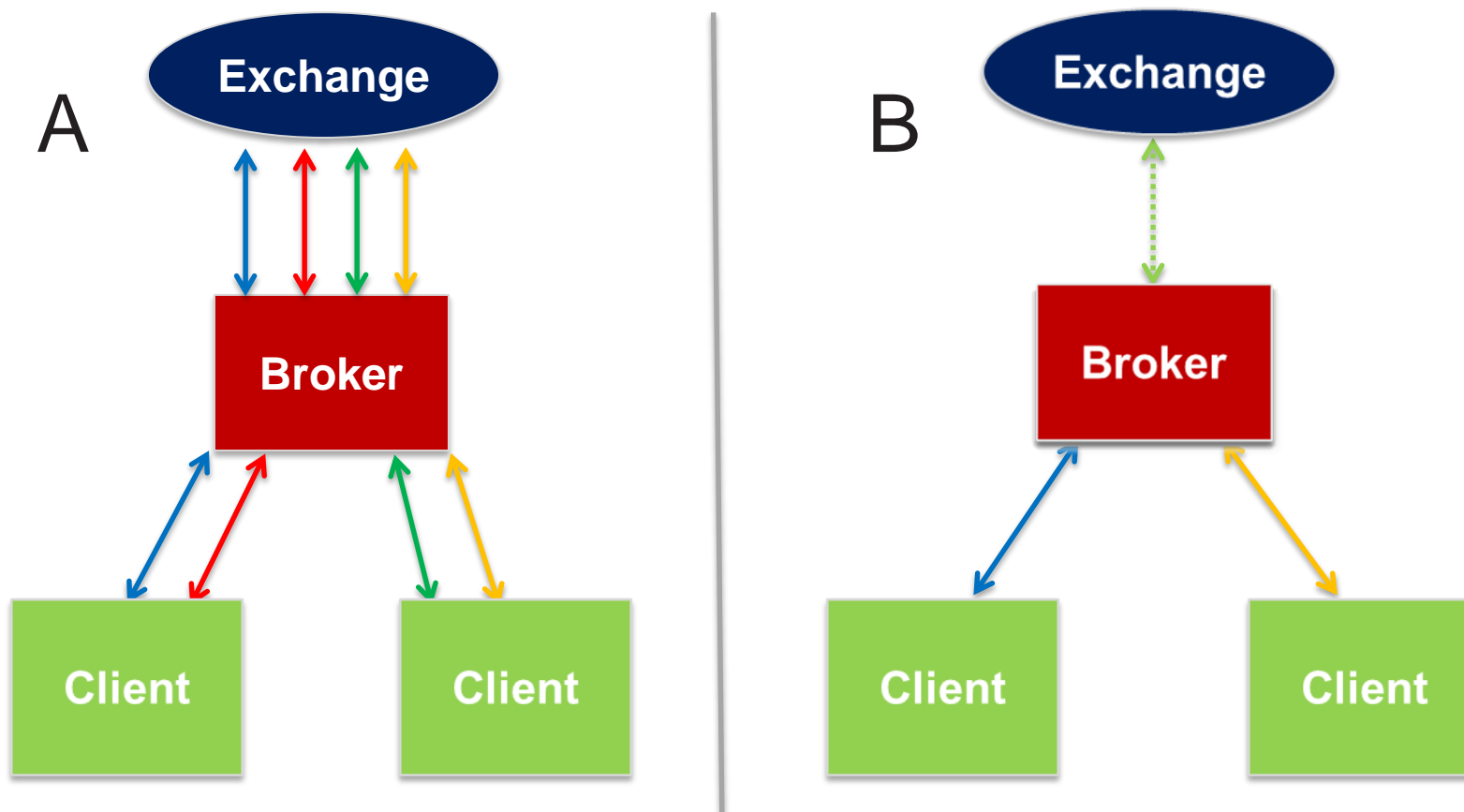


Intermediaries/customers

- Positions held by intermediary on behalf of a customer do not count towards that intermediary’s own position limits (even if held as principal)

MiFID2/R: ESMA FR Sept 2015 – “Person” (contd)

Q: When is an intermediary not an intermediary?

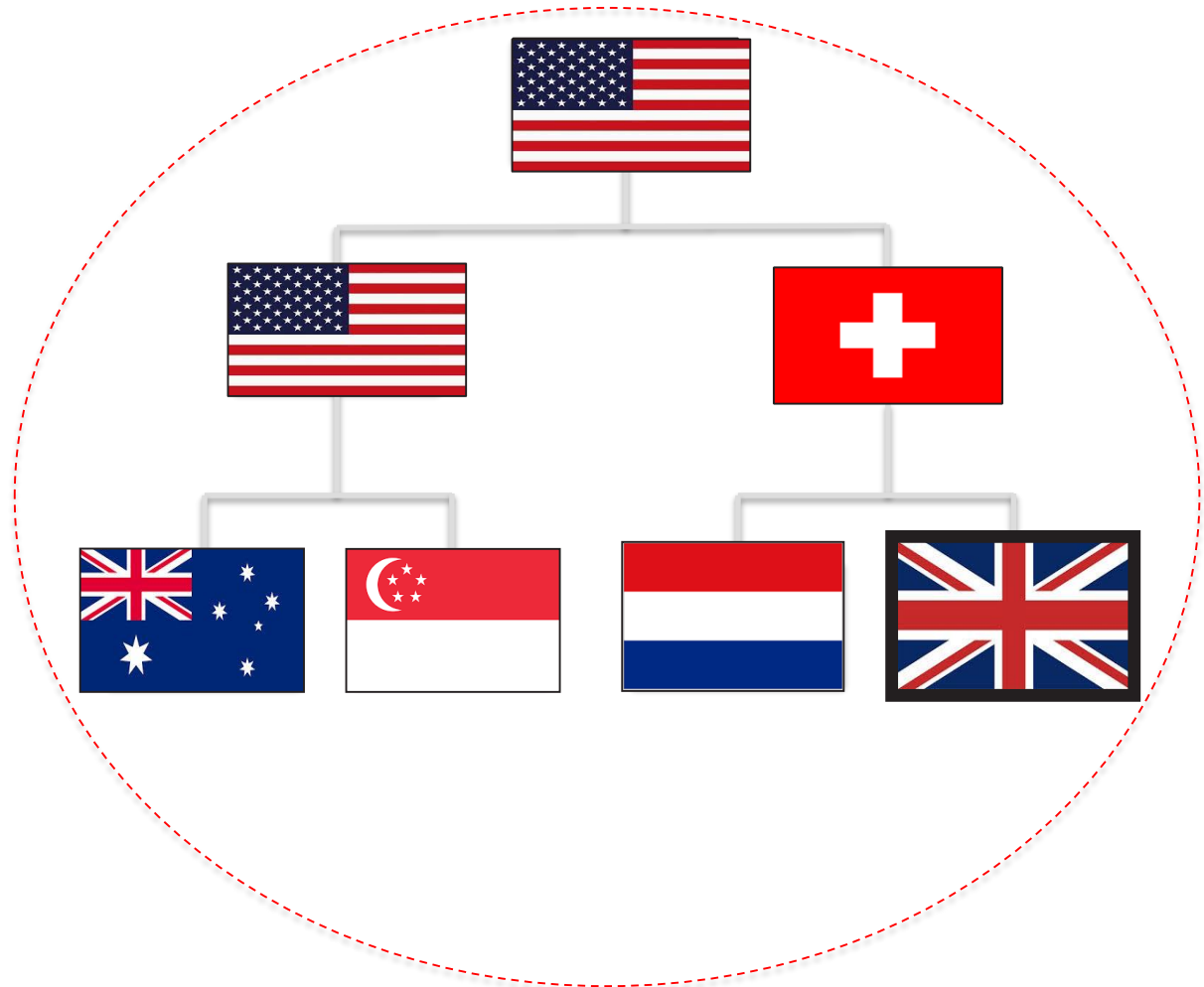


MiFID2/R: ESMA FR Sept 2015 – Aggregation

Aggregation

“Positions held by a person and those held on its behalf at an aggregate group level”

- Group-wide
- Consolidated Accounting Directive
- Full size of a position counted
- Generally no aggregation/disaggregation based on trading control/independence
- Limited fund manager exception



MiFID2/R: ESMA FR Sept 2015: Hedging Exemption

Hedging Exemption

- **“Non-Financial Entities” only**
 - Excludes MiFID2 firms (and other FCs)
 - Third country firms have a counter-conditional analysis
- **Notifications to NCAs of relevant trading venues**
 - 30 day processing time down to 21 days.
 - But still need exemption in advance of trade.
 - What will application process be like?



MiFID2/R: ESMA FR Sept 2015 – Methodology

Two Limit Types

- Spot month (defined broadly)
- All other months



Baselines for Spot

- 25% of “Deliverable Supply” (tangible commodities)
- Deliverable supply defined:
 - *meets the delivery specification of a CDTV, and*
 - *expected to be readily available for settling that type of CDTV at the contract’s delivery points during the spot month delivery period as specified on the TV*
- 25% Open interest for intangibles (C10)

MiFID2/R: ESMA FR Sept 2015 – Methodology

Baseline All Other Months

- 25% of open interest (all types)

Securitised Derivatives Baseline

- 25% of securities in issue

All Baselines can be adjusted

- 5% to 35% range permitted
- Adjustment only permitted by reference to the 6 factors

New or illiquid contracts

- 2,500 lot limit (2.5m security limit)
- Where total combined open interest 10,000 lots (or 10m issued securities) or under, over a 3 month period



MiFID2/R Transparency – Requirements on TVs

Pre-trade

- Make public bid/offer prices and depth of trading interest for “actionable indications of interest” (**IOIs**)
- **CA may grant waivers:**
 - Not liquid
 - Large in Scale (**LIS**)
 - Size Specific to Instrument (**SSTI**) where RfQ/voice trading system

Post trade

- Make public volume, price and time of transaction etc: trade-by-trade or aggregated
- **CA may grant deferrals (on same basis):**
 - No more than 48 hours
 - Info other than volume or aggregated details must be published during that period

MIFID2/R: Transparency Requirements on SIs

Pre-trade

- Must provide quotes in liquid instruments where asked by clients and make available to other clients
- Must trade if up to certain size and subject to transparent limits
- Price improvement permitted in justified cases

Post-trade

- Where transaction concluded outside a TV, firms must make trades public through an Approved Publication Arrangement (APA)
- Within 15 minutes (5 minutes from 2020)
- Same timings, deferrals and suspensions as for TVs

MiFID2/R: ESMA FR Dec 2014- Systematic Internaliser (SI)

“An investment firm which, on an organised, frequent, systematic and substantial basis deals on own account by executing client orders outside a RM, MTF or OTF”



- “Deal on own account when executing client orders” outside a TV
- “Frequent and systematic” (Level 2)
- “Substantial basis” (Level 2)

Systematic Internaliser (SI) – ESMA CP Dec 2014

		Derivatives
Frequent and systematic basis thresholds: <i>Liquid classes</i>	Number of transactions executed by the investment firm on own account OTC /total number of transaction in the same financial instrument in the EU	2 to 3% and at least once per week
<i>Illiquid classes</i>	Minimum trading frequency (average during last 6 months)	At least once a week
Substantial basis thresholds: <i>Proportion of own activity</i>	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument executed by the investment firm	25%
OR <i>Proportion of market activity</i>	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument in the EU	0.5 to 1.5%

MiFID 2/R – Ancillary Business Exemption – ESMA Final Report 28 Sept 2015

ANCILLARY BUSINESS EXEMPTION

“Trading Activity” test (by asset class): $\frac{\text{Size of Trading Activity (in EU market)}}{\text{Overall market size (in EU market)}}$

“Main Business” test (all asset classes): $\frac{\text{Relevant Trading Activity (Global)}}{\text{Total Size of Trading in (Global)}}$



KEY CONCEPTS

Trading activity: CDs, EAs and EADs

Privileged Transactions: “risk-reducing trades”; intra-group trades which are exempt from EMIR; and compulsory liquidity provision

Transactions by MiFID2 authorised firms (in same group)

MiFID 2/R (contd) – Ancillary Business Exemption

MAIN BUSINESS TEST RESULT	TRADING ACTIVITY TEST (% of activity in the EU market)							
	Oil & Oil Products	Gas	Power	Coal	Metals	Agri	Other (incl. freight & C10)	Emissions & EADs
< 10%	3%	3%	6%	10%	4%	4%	15%	20%
10% to 50%	1.5%	1.5%	3%	5%	2%	2%	7.5%	10%
> 50%	0.6%	0.6%	1.2%	2%	0.8%	0.8%	3%	4%

MiFID 2/MiFIR – Ancillary Business Exemption – ESMA Final Report 28 Sept 2015

KEY ISSUES

- Not self-executing – annual application
- Hedging Definition
- Highly problematic transitional regime
- Definition of spot vs physical forward



MiFID2/MiFIR Timeline...?

OFFICIAL TIMETABLE (SUBJECT TO CHANGE...)

- 3 July 2016** Current transposition deadline for MiFID2
- 3 Jan 2017** MiFID2/MiFIR application
- 31 Dec 2017** Specialist commodity firm exemptions under articles 493/498 of CRR expire (but likely extension to 31 Dec 2020)
- 3 July 2020** End of transitional period for oil & coal



Paul Willis, Technical Specialist – Commodities, FCA

MIFID 2

FIA Europe Infonet
20 November 2015

Paul Willis, Financial Conduct Authority

Legislative timing overview

- **Level 1 Directive & Regulation**

- *Finalised 17 January 2014*

- **Level 2 Regulatory & Implementing Technical Standards**

- *To Commission from Sept. to Dec. 2015*

- **Level 3 work**

- *Rules, Guidelines and Q&A from ESMA and FCA during 2016...*

Transitional arrangements

- There aren't any in the Level 1 text...
- The European Commission has confirmed that it expects "day one" readiness on implementation
- Therefore industry timetabling should reflect legislative requirements
- Recent developments may change this

Definition of “commodity derivative”

- The definition of “commodity derivative” is defined in Level 1 and has quirks in its perimeter that will challenge firms’ implementation and ongoing compliance with MIFID2
- “REMIT carve-out” derivatives are physically settled on the new OTF type of trading platform
- “Securities based on a commodity underlying” are **included**, although not shares nor bonds. This excludes the majority of commodity ETFs and ETNs

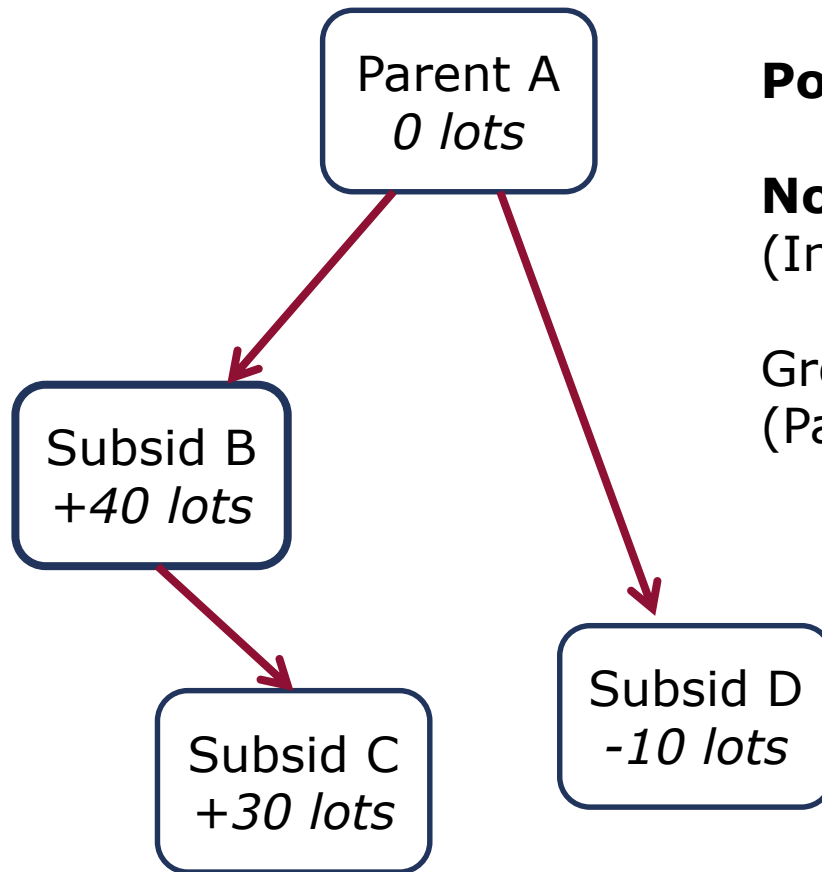
Position Limits (1)

- An entirely new concept at NCA level rather than trading venue level. Limits to be set and enforced for **all** commodity derivatives on all EU trading venues.
- A de minimis regime is proposed for new and illiquid contracts to avoid damaging liquidity and commercial activity.
- For non-financial entities, positions hedging commercial activities may be exempted from limits. No such exemption, either proprietary or “pass-through” is available to regulated firms. This makes the Ancillary test yet more contentious.

Position Limits (2)

- Includes “Economically Equivalent OTC Contracts”
 - “EEOTC” is determined by the persons entering into the OTC and appropriate classification will be checked by NCA supervision. A list of EEOTC contracts will **not** be published
- Netting: two buckets for “Spot” and “Other Months” that covers all expiries other than the Spot Month.
- Add together long and short positions:
 - ETDs
 - “Same” contracts
 - EEOTCs

Model for group aggregation



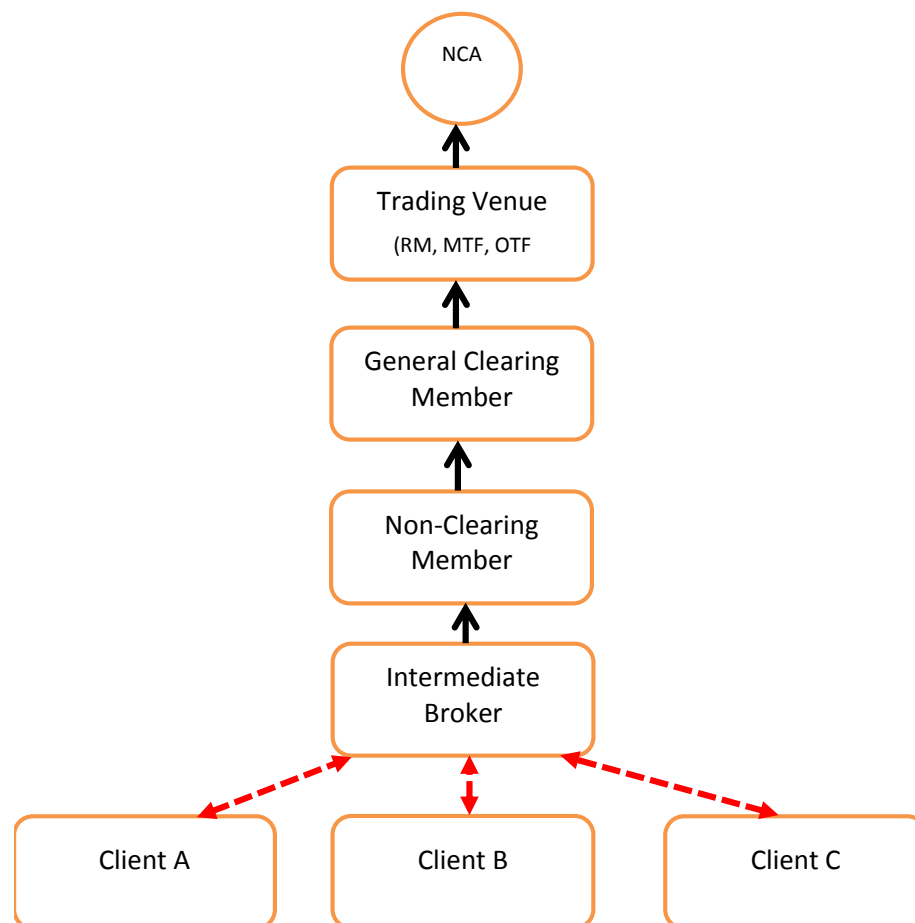
Position limit: 50 lots

No single entity in breach
(Individually: 0, 40, 30, 10 < 50)

Group **is** in breach
(Parent: $0 + 40 + 30 - 10 = 60$)

All ownership relationships are 100%

Position Reporting – in a picture



Position Reporting

- ESMA is only mandated to define the report template for the OTC reporting by investment firms
 - Not the template for the Exchange Traded Derivative reports from Trading Venues
 - Not the mechanism by which data will flow
 - Not how to resolve EU and third country privacy issues
- ESMA will attempt to clarify these issues in its Level 3 work whilst still delivering the outcome intended by the co-legislators

Transparency and EFPs

- Question arising about whether EFPs are in or out of the “package” trade definition
- Identified that this is a Level 1 issue arising from the legal interpretation of the text
- Appears to be a recognition of the issue on all sides of the concerns
- Remains to be seen if or what solution is possible without a Level 1 text revision

Regulatory approach

- FCA will take a pragmatic approach recognising that firms cannot achieve the impossible
- The real crime is failing to prepare rather than failing to meet all your obligations

Thank you

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Questions from the floor