



## SPECIAL REPORT: COMMODITY DERIVATIVES UNDER MiFID II

9 June, 2014—This Special Report is the second in the FIA and FIA Europe’s series covering specific areas of the European Securities and Markets Authority’s consultation process for the implementation of the recast Markets in Financial Instruments Directive (“MiFID II”) and Regulation (“MiFIR”). It provides an overview of the proposals for commodity derivatives set out in both the recently published Consultation Paper<sup>1</sup> and Discussion Paper<sup>2</sup>, including draft technical advice measures and proposed draft Regulatory Technical Standards (“RTS”) and proposed draft Implementing Technical Standards (“ITS”).

### SPECIFICATION AND DEFINITIONS OF COMMODITY DERIVATIVES UNDER MiFID II

MiFID II has broadened the list of financial instruments previously captured under MiFID I to include commodity derivatives. Exemptions for firms from MiFID II are available under Article 2 of the Directive. For example, if a firm’s commodities trading business is “ancillary” to its primary business, can be described as “reducing risks directly related to commercial activity” or “includes transactions entered into to fulfil liquidity obligations on a trading venue.”

Section C of Annex I of MiFID II sets out in greater detail the types of commodity derivatives covered by MiFID II/MiFIR. The ESMA consultation paper (“CP”) focuses on commodity derivatives covered by Sections C5, 6, 7 and 10 of Annex I, which includes options, futures, swaps and other derivative contracts relating to commodities which can be physically settled or cash settled, and are traded on Organised Trading Facilities (“OTFs”), Multilateral Trading Facilities (“MTFs”) or Regulated Markets<sup>3</sup>. The CP also covers derivative contracts that are not for commercial purposes, are similar to other derivatives and have other more specific characteristics (such as those in C10 relating to climatic variables, freight rates, inflation rates or other economic statistics).

However, Section C6 of Annex I excludes wholesale energy products within the scope of the Regulation on Wholesale Energy Market Integrity and Transparency (“REMIT”)<sup>4</sup> that are traded on an OTF and that must be *physically* settled. As a result, these excluded wholesale energy products do not qualify as financial instruments and are consequently outside the scope of MiFID, the European Markets Infrastructure Regulation (“EMIR”)<sup>5</sup> and the CRD IV package.

ESMA clarifies that C6 energy derivatives with coal or oil as an underlying can, upon agreement with a National Competent Authority (“NCA”), be exempted from the clearing obligation and risk

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<sup>1</sup> ESMA Consultation Paper (ESMA/2014/549); Click [here](#) for the full text of the Consultation Paper.

<sup>2</sup> ESMA Discussion Paper (ESMA/2014/548); Click [here](#) for the full text of the Discussion Paper.

<sup>3</sup> A Regulated Market is defined as one on a list of such markets within the European Economic Area (“EEA”) maintained on the website of the European Commission. A MTF is a non-exchange financial trading venue, operated by an investment firm or market operator. An OTF will include all forms of organised execution and arranging of trading which do not currently fall within existing categories of trading venue.

<sup>4</sup> Regulation (EU) No. 1227/2011

<sup>5</sup> Regulation (EU) No. 648/2012

mitigation requirements under EMIR for a transitional period of six years after MiFID II enters into force. ESMA is seeking input as to which oil contracts should fall within this exemption.

The draft technical advice also clarifies ESMA's definition of "must be physically settled." Those contracts which must be settled in cash fall within C5, and those which *can* be or *must* be physically settled will fall within C6 or C7. The advice also states that the term "physically settled" will now incorporate a broad range of delivery methods.

For C7 and C10 contracts, the existence of clearing arrangements is no longer an indicator of whether they fall within MiFID II. References to clearing arrangements have, therefore, been deleted. These modifications are of particular import for FIA and FIA Europe Members to the extent clearing arrangements incorporate definitions of C7 and C10 contracts.

ESMA proposes to broaden the definition of "for commercial purposes" since it is currently limited to the energy sectors. In addition, contracts should be considered as having the characteristics of other derivative financial instruments where they are standardised and trade in line with specific requirements. The existing parameters contained within MiFID I for C10 derivatives should be kept, but ESMA is considering adding actuarial statistics as a specific type of contract under this class. In all cases, ESMA is looking to ensure that the MiFID II and MiFIR definitions fit in with, and complement, the new European Market Abuse Regulation ("MAR"), the REMIT and EMIR.

## **POSITION REPORTING THRESHOLDS**

MiFID II requires trading venues where commodity derivatives are traded to publish a weekly report showing aggregate positions market participants hold in various commodity derivatives. This report will be known as the "Commitment of Trader Report" ("COTR"), which should be familiar to market participants regulated by the United States' Commodity Futures Trading Commission ("CFTC"). Under MiFID II, COTRs only need to be published where both the number of persons and their open positions exceed minimum thresholds; however, trading venues intend to use COTRs to increase market transparency and, therefore, intend to publish these reports weekly.

ESMA proposes that the minimum number of position holders across the categories of persons needed to trigger the reporting requirement be set at a total of 30. In addition, where the gross total open position of a derivative exceeds four times the deliverable supply in it, the obligation will be triggered. The obligation to report will continue for a period of three months after a contract exceeds both of the thresholds, however, the requirement to report ceases if the thresholds have not been met during the three-month period. ESMA noted that this methodology reduces sporadic reporting.

## **ANCILLARY ACTIVITIES**

MiFID II looks to narrow the parameters of possible exemptions which allow trading of commodities by firms as an ancillary activity. Some firms previously excluded from the MiFID regime will now fall within scope, and, firms which remain outside scope will need to explain the basis on which they utilise the exemption and may have to comply with organisational requirements for algorithmic trading.

Where a firm cannot use an exemption under MiFID II, it will fall within the CRD IV regime<sup>6</sup>. Further, investment firms within the scope of MiFID II would be considered financial counterparties under EMIR.

ESMA considers the exemption at Article 2(1)(j) of MiFID II in detail. To use this, the commodity derivative trading activities of a firm must be ancillary and constitute a minority of activities at group level. In order to define “minority,” ESMA may consider the capital used to carry out the activity relative to the capital needed for carrying out the main business. It will look at whether the ancillary activity accounts for less than 50% of the main business of the group. Certain types of hedging transactions may be excluded from these calculations.

A firm’s trading activity also has to be compared with the size of the overall market’s trading activity. ESMA wishes to capture firms that have a relatively high level of trading activity in comparison to authorised firms in a specific asset class, or generally. However, it wishes to capture the size of the firm’s trading activity in the European Union (“EU”) rather than all trading activity globally. It notes that there may be practical difficulties in doing so.

ESMA suggests that where an entity passes the threshold for one asset class, it would be subject to MiFID for all of its activities. Firms which breach the trading activity threshold will fall within MiFID II, even if they do not breach the capital threshold test.

ESMA recognises that there are practical difficulties in defining the calculation period. It is considering whether to have an annual test in relation to the exemptions based on an audit report, or whether to determine qualification for the exemptions on the basis of a rolling average over three years.

## **POSITION LIMITS**

ESMA discusses the factors that NCAs will use in establishing limits on the size of a person’s net position in a commodity derivative and in determining the methodology for its calculation.

### **FACTORS FOR POSITION LIMITS**

Position limits will not apply to positions of a non-financial entity which are used for commercial hedging activities. ESMA recommends that the interpretation of risk-reducing activity and non-financial entity should be consistent with that contained within EMIR for OTC trades.

The limits shall apply on the basis of all positions held by a person and also those held on its behalf at an aggregate group level. This will require the aggregation of a person’s positions with those of any wholly or partly owned subsidiaries of that entity, but not the positions of fellow subsidiaries of a mutual parent or ultimate holding company. Where necessary, it will include the full amount of the relevant positions, and not merely the percentage that reflects the proportion of ownership.

Position limits will apply to commodity derivatives traded on a trading venue and “economically equivalent OTC contracts,” which are contracts equivalent to listed contracts. ESMA proposes two approaches to assessing the characteristics of OTC contracts for this purpose, including consideration of market practices in other jurisdictions, such as the CFTC proposals in relation to “Core Referenced Futures Contracts.” Contracts that are ‘cross-listed’, meaning listed on more than

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<sup>6</sup> Capital Requirements Directive (2013/36/EU) and Capital Requirements Regulation (EU) No. 575/2013

one trading venue, should be defined as the “same” commodity derivative for the purposes of position limits.

ESMA also considers rules on how to calculate a net position, and the extent to which a position executed on a trading venue should be aggregated or netted with activity elsewhere. Physical holdings of an underlying commodity should be excluded, but holdings in identical contracts across different positions and securities contracts should be included.

Non-financial entities that hold positions for risk-reduction purposes may be exempted from the position limits regime. ESMA proposes that entities that are exempt (including those incorporated outside the EU) should make a notification to the NCA of the relevant trading venue. Competent authorities will have up to 30 calendar days to consider and respond to such notifications.

ESMA also proposes an approach to defining market size for both physically settled and cash settled derivatives contracts, including using the underlying commodity. Where it is necessary to determine the venue on which the largest volume of trading in a commodity derivative takes place, ESMA proposes that this will be the venue on which the largest volume of open interest is held.

#### **METHODOLOGY FOR CALCULATING POSITION LIMITS**

MiFID II sets out seven factors that may affect the methodology to be used in calculating position limits, including maturity and volatility. ESMA acknowledges that the application of the individual factors may be different depending on the nature of the contract used and the intended settlement method. ESMA has requested feedback on any other factors which could be included in the methodology for calculation.

The proposed approach for setting position limits will depend on the particular market involved and the asset class of the derivative contract. NCAs should be able to calculate the limit to be applied for any particular contract on a trading venue using a baseline that is then adjusted upwards or downwards, depending on the specific characteristics of a contract.

### **POSITION MANAGEMENT POWERS**

NCAs will supervise adherence to position limits set by ESMA and will be granted powers in relation to: requiring information on positions, reducing the size of positions, and having the ability to limit persons entering into commodity derivatives. ESMA will be granted comparable powers, but will only be allowed to use them in exceptional circumstances and only where there exists both an emergency situation and a failure or inability of a NCA to take appropriate action. ESMA notes that the circumstances related to other powers available to it in other legislation, such as the Short Selling Regulation,<sup>7</sup> may be of different relevance for the financial and commodities derivatives.

### **POSITION REPORTING**

Under MiFID II investment firms, trading venues, trading venue members and participants must provide data and produce and publish position reports for commodity derivatives. A position should be defined as the net accumulation of buy and sell transactions in a particular commodity derivative at a specific point in time that has yet to be closed out, expired or exercised. This can be defined as the “open interest” controlled by a person. All positions should be reported on a gross basis and as either long or short.

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<sup>7</sup> Regulation (EU) No. 918/2012

Persons located outside the EU who are members or participants of regulated markets, MTFs or clients of OTFs will be required to report their positions and those of their clients. Underlying clients must be identified and ESMA recognises that there are confidentiality and commercial interest concerns in doing this. ESMA proposes using LEIs, BICs and national codes to identify persons in reports.

ESMA proposes that where the same contract is traded on multiple trading venues in different Member States, the positions should be reported to the NCA where the most significant volume of on-venue contracts is traded.

Position reporting will need to capture each individual maturity held in each commodity derivative. NCAs will also need to link on-venue contracts and economically equivalent OTC contracts which are deemed to be “the same.” ESMA recommends using the reporting formats in place for EMIR trade reporting and those being considered for transaction reporting under MiFID II. New fields would be required in order to accommodate specific data for position reporting.

Trading venues and Trade Repositories may be asked to provide reference data on on-venue and economically equivalent OTC contracts to help firms with position reporting. As an alternative, ESMA is considering using Approved Reporting Mechanisms for position reporting.

## UPCOMING ESMA HEARINGS: COMMODITY DERIVATIVES AND OTHER ISSUES

On 3 June 2014, ESMA announced that it would hold an open hearing on commodity derivatives as set out in its Discussion paper and Consultation paper on MiFID II/MiFIR. The open hearing will take place on 8 July 2014. Additional details on the hearing are located [here](#). ESMA will also hold open hearings on market issues on 7 July 2014 and investor protection issues on 8 July 2014. Additional details on these hearings are located [here](#).

## UPCOMING SPECIAL REPORTS

In the coming weeks, FIA and FIA Europe will issue will issue special reports on several topics addressed in the consultation:

- 1) **Open Access** (access to central counterparties, trading venues and benchmarks)
- 2) **Market Infrastructure** (requirements for organisation of new trading venues and impact of the new obligation to trade on those venues)
- 3) **Investor Protection**
- 4) **Algorithmic and High Frequency Trading** (defining terms and regulating activities)
- 5) **Third Country Access** (treatment of third country firms accessing EU customers)
- 6) **Reporting of Instruments**
- 7) **Transparency Requirements for Instruments**

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Additional MiFID II/MiFIR documents are available [here](#).

*Disclaimer: This report was drafted in conjunction with the London office of Covington & Burling LLP on behalf of FIA and FIA Europe. The report is part of a series of reports intended to provide factual summaries of MiFID/MiFIR on certain topics of interest to the members of FIA and FIA Europe. The reports are provided for general informational purposes only. They do not constitute legal or regulatory advice and should not be relied upon for this purpose.*

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