FIA AND FIA EUROPE SPECIAL REPORT SERIES: COMMODITY DERIVATIVES UNDER MIFID II

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This Special Report is the fifth in a 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 II (2014/65/EU) and Markets in Financial Instruments Regulation (Regulation 600/2012), which together are referred to as "MiFID II" and come into effect on 3 January 2017. On 19 December 2014, ESMA published Final Technical Advice to the European Commission (ESMA/2014/1569), together with a Consultation Paper (ESMA/2014/1570), on MiFID II. The Consultation Paper includes draft Regulatory Technical Standards ("RTS") and implementing Technical Standards ("ITS"), which ESMA is required to produce under MiFID II.

This Special Report offers an overview of ESMA's proposals in the Final Technical Advice and the Consultation Paper as well as the draft RTS and ITS on the specific requirements for commodity derivatives. ESMA previously set out its initial proposals on these requirements in its Consultation Paper (ESMA/2014/549) and Discussion Paper (ESMA/2014/548) published in May 2014.

SPECIFICATION AND DEFINITION

MiFID II has broadened the list of financial instruments previously captured under MiFID I to include commodity derivatives traded on an organised trading facility ("OTF"). The Final Technical Advice from ESMA provides proposals to the European Commission on a) specifying when wholesale energy contracts referred to in Section C6 of Annex I to the recast Directive are considered contracts that "must be physically settled", and b) whether any amendments are necessary to Article 38 of the MiFID I Commission Regulation Nº1287/2006 for the purpose of specifying derivative contracts in Section C7 and C10 that have the characteristics of other derivative instruments.

a) C6 - physically settled energy contracts

Contracts falling within the new definition of C6 under the recast Directive will include options, futures, swaps and other derivative contracts relating to commodities that can be physically settled and are traded on an OTF, as well as contracts traded on multilateral trading facilities ("MTFs") and Regulated Markets. Wholesale energy products within the scope of the Regulation on Wholesale Energy Market Integrity and Transparency (Regulation 1227/2011) ("REMIT") which are traded on OTFs and must be physically settled are specifically excluded.

C6 energy derivatives contracts with coal or oil as the underlying may, with agreement from a National Competent Authority, be exempted from the clearing and risk mitigation requirements under the European Markets Infrastructure Regulation ("EMIR") for a transitional period of six years after MiFID II enters into force. In the May Consultation Paper, ESMA asked which oil contracts should fall within this exemption. Following feedback, ESMA has broadened the definition of "oil" in the Final Technical Advice to include mineral oil and petroleum gases, as well as products, components and derivatives of oil and oil transport fuels, including bio-fuel additives but not pure biofuel.

On the meaning of "must be physically settled", ESMA has clarified that for a contract to qualify, parties need to have proportionate arrangements in place to be able to make or take delivery of the underlying. There should also be unconditional, unrestricted and enforceable obligations to physically deliver, limited provisions to off-set obligations and no rights to replace physical settlement with cash, except in the case of a force majeure event or other bona fide inability to settle physically. The definition of "physically settled" in the Final Technical Advice incorporates a wide variety of delivery methods, including evidence of transfer of ownership.

b) C7 and C10 - contracts with characteristics of other derivative financial instruments

ESMA confirms its previous approach to defining C7 contracts and recommends that contracts should be considered as having the characteristics of other derivative financial instruments, provided they are standardised, trade in line with specific conditions laid down in the Final Technical Advice and are neither spot contracts nor contracts "for commercial purposes". ESMA proposes to maintain the current definition of commercial purpose in Article 38 of MiFID I, being that a contract entered into with or by an operator or administrator of an energy transmission grid, balancing mechanism or pipeline network, so as to keep in balance supplies and uses of energy at a given time, will be "for commercial purposes". Contracts which fall within the exemption for C6 should not be tested again under C7.

The existence of clearing arrangements is no longer an indicator of whether contracts which could be C7 or C10 would fall within Annex I. References to clearing arrangements remain deleted in the Final Technical Advice and these modifications are of interest to FIA and FIA Europe members to the extent clearing arrangements incorporate definitions of C7 and C10 contracts. In addition, ESMA confirms its proposal to delete the words “expressly stated to be” from the equivalence requirement in Art 38 (1)(a)(iii).

The definition of C10 contracts remains almost unchanged from the May Consultation Paper. However, contracts can now qualify as C10 where they are traded on a third country venue similar to an OTF, MTF or Regulated Market.

ESMA has not proposed any changes to the definition of spot contracts in Article 38 of MiFID I but reserves the option to look at this point again in future guidelines, once MiFID II reaches the implementation stage.

ANCILLARY ACTIVITIES

MiFID II narrows the scope of exemptions available to firms which trade in commodities derivatives as an ancillary activity. The applicable exemption is set out at Article 2(1)(j) of the recast Directive. The Consultation Paper explores how ESMA should best take into account the criteria set out at Article 2(4) of the recast Directive for determining whether an activity is ancillary for the purposes of this exemption.

In order for commodities derivatives trading activities to be considered ancillary to a firm's main business (which must not be MiFID investment business), such activity must constitute a minority of activities at the group level. In addition, firms must consider the size of their trading activity compared to the size of the overall EU market's trading activity in the particular commodity derivative. In the Consultation Paper, ESMA translates those criteria into two threshold tests and proposes that firms exceeding either threshold will be caught by MiFID II.

Under the first test, where a firm's capital employed for its eligible activities in the European Union constitutes more than 5% of the capital employed for the overall activities of the global group, it will fall within scope of MiFID II. Eligible activity comprises activities listed in Article 2(1)(j) of the recast Directive. Privileged transactions (which include certain liquidity obligations, intra-group and risk reducing transactions) will be deducted from the eligible activity. Capital employed for trading activity carried out by MiFID authorised members of the group will not count towards the calculation. ESMA clarifies that a group may establish a subsidiary in which all MiFID II activities requiring authorisation are bundled.

Under the second test, a firm will be caught by MiFID II if the size of the commodity derivatives trading activity by its group in the European Union constitutes more than 0.5% of the overall market trading activity in the European Union in any of the eight specified commodity classes. These include: metals, oil and oil products, coal, emission allowances, gas, power, agricultural products, and other commodities (including freight and commodities under C10 of Annex I to the recast Directive). MiFID II will apply to firms that exceed the threshold in any of the commodity classes. Again, privileged transactions will be deducted from the trading activity and trading carried out by MiFID authorised members of the group will not count towards the calculation. ESMA further proposes a *de minimis* threshold of 0.25%. Entities whose commodity trading activity falls below this level will not have to apply the first test in order to be able to invoke the ancillary exemption.

ESMA confirms its proposal to define the calculation period for the ancillary activities exemption on the basis of a rolling average over three years from 2020. It proposes certain transitional arrangements between 2017 and 2020. Firms wishing to invoke the ancillary exemption will need to notify the National Competent Authority annually.

Where a firm may not rely on an exemption, it must obtain authorisation to carry on any form of MiFID business and comply with other regulations, such as EMIR and capital requirements under the Capital Requirements Directive (Directive 2013/36/EU and Regulation 575/2013 together known as "CRD IV").

In addition, firms falling within scope of MiFID II will be considered financial counterparties under EMIR.

POSITION LIMITS

Under Article 57 of the recast Directive, national competent authorities, in line with the methodology for calculation determined by ESMA, shall establish and apply position limits on the size of a net position which a person can hold in commodity derivatives traded on trading venues and economically equivalent OTC contracts. In the Consultation Paper, ESMA has refined its proposals concerning the factors set out under Article 57 of the recast Directive for national competent authorities to use in establishing limits and in determining the methodology for its calculation.

a) Application

Position limits shall not apply to positions held by or on behalf of a non-financial entity which are objectively measureable as reducing risks directly relating to commercial activity (i.e. hedging). ESMA proposes that a "non-financial entity" should include any entity which is not a financial institution under any relevant European Union legislation, including third country equivalent entities. ESMA confirms in the Consultation Paper that Recital 21 of the recast Directive requires risk reducing activities to be considered in a manner consistent with Regulation (EU) No 648/2012 ("EMIR").

In order for position limits to be correctly applied to all positions held by a person, aggregation within a group may be required. Article 2 of draft RTS 30 proposes that the aggregation include a person's positions (whether held directly or indirectly through third parties) and those of any wholly or partly owned subsidiaries of a mutual parent or ultimate holding company. ESMA proposes that commodity derivative positions should be aggregated on a "whole position" basis with those under beneficial ownership. Where an entity partially owns another firm it must aggregate the position of that firm in its entirety and not only on a pro rata basis according to the percentage of its holding. ESMA understands that this may lead to double counting.

Position limits will also apply to OTC derivatives contracts which are "economically equivalent" to exchange traded contracts. The Consultation Paper proposes that for an OTC contract to be "economically equivalent", it should be referenced to a contract traded on a trading venue in the European Union, or it should have fundamentally the same characteristics with regard to contract specification as the exchange-traded one. ESMA believes that the scope for economically equivalent contracts should be narrow, so as not to dilute the integrity of position limits.

Where an identical contract is traded independently on two or more trading venues within the European Union, Article 57 (6) of the recast Directive states that the competent authority of the trading venue where the largest volume of trading takes place shall set the single position limit for this contract, which ESMA defines as the "same" contract. ESMA's proposals to define the method for determining the venue on which the largest volume of commodity derivatives trading takes place are set out in RTS 30 (7).

ESMA proposes in RTS 30 the methodology for aggregating and netting OTC and exchange-traded commodity derivatives positions. The RTS do not cover rules on netting and aggregation of positions on third country venues and ESMA considers the geographical scope to be limited to the European Union. In addition, ESMA envisages that it is not appropriate to require the aggregation or permit the netting of wholesale energy products which are subject to REMIT as they are not financial instruments under MiFID II. It confirms that physical holdings of an underlying commodity are also excluded.

Non-financial entities that hold positions for risk-reduction purposes may be exempted from the position limits regime. ESMA confirms that the exemption does not apply universally to a type of entity, but applies to holdings in specific contracts which are held for risk-reduction purposes. RTS 30 (6) states that entities which qualify (including third country entities) must make a notification of exemption to the competent authority of the relevant trading venue. National competent authorities will have 30 calendar days to consider and respond to such request for exemption.

b) Calculation methodology

ESMA proposes to maintain the methodology for calculating position limits set out in the previous Discussion Paper, and to set position limits for both cash settled and physically settled contracts with reference to the deliverable supply. Article 57 (3) of the recast Directive prescribes that ESMA take into account seven factors, which include: maturity, deliverable supply, open interest, volatility, number and size of market participants, characteristics of the underlying commodity market, and the development of new contracts. ESMA proposes in RTS 29 (1) that the baseline figure for the position limit for the spot month and other months for each commodity derivative will be 25% of deliverable supply. The Consultation Paper did not define the term "deliverable supply". National competent authorities will have the power to adjust this baseline figure by an absolute value of plus or minus 15% to the extent necessary when considering the potential impact of the seven factors. ESMA will publish and maintain a list of position limits on its website, as required by Article 57 (10) of the recast Directive.

POSITION REPORTING

Article 58(1) of the recast Directive requires investment firms and persons operating trading venues where commodity derivatives, emission allowances or derivatives thereof are traded to (a) publish a weekly Commitment of Trader Report ("COTR"), showing aggregate positions that market participants hold in various commodity derivatives, provided that both the number of persons and their open positions exceed the minimum thresholds set out below, and (b) provide the competent authority with a complete breakdown of positions held by all persons (including clients of members or participants) on that trading venue on at least a daily basis.

ESMA states in its Final Technical Advice that the minimum thresholds for a weekly COTR are exceeded where 30 open position holders exist in a given contract on a given trading venue, and where the absolute amount of the gross long or short volume of total open interest (expressed in the number of lots of the relevant commodity derivative) exceeds a level of four times the deliverable

supply in the same commodity derivative. Where the obligation is triggered, a trading venue must publish its first report no later than three weeks after the threshold was triggered. The requirement ceases where the thresholds have not been met for a period of three months. Reporting may cease automatically where a contract expires or is delisted during the reportable period.

In addition, under Article 58(2) investment firms which trade in commodity derivatives or emission allowances or derivatives thereof outside of a trading venue must provide their national competent authorities with a daily position breakdown report called a "Position Report", which must provide information on their positions held on a trading venue, economically equivalent OTC contracts, and positions of their clients and the clients of those clients until the end client is reached.

In draft ITS 31 ESMA sets out the formats for the COTR and Position Report, together with the required fields. It confirms that, where appropriate, it will continue to seek to use reporting formats from other market or regulatory initiatives, including transaction reporting under MiFID II. It has not been mandated to define the reporting format for trading venues providing daily reports under Article 58(1)(b), which may give rise to inconsistences in implementation.

UPCOMING SPECIAL REPORTS

In the coming days, FIA and FIA Europe will issue additional special reports on the topics addressed in the Consultation Paper:

1. Open Access
2. Transactions Reporting

For more information about these reports contact Will Acworth at FIA (wacworth@fia.org) or Emma Davey at FIA Europe (edavey@fia-europe.org)