16 February 2024

Response to FCA commodities consultation CP23/27

FIA welcomes the opportunity to provide feedback on the FCA's approach to reforming the commodity derivatives regulatory framework.

FIA members support the FCA's goals of promoting market integrity and resilience and preventing disorderly trading and settlement in the commodity markets. Members welcome many of the proposals included in the consultation, in particular:

- the introduction of a pass-through hedging exemption;
- the liquidity provider exemption;
- narrowing the scope of the position limits regime to critical contracts;
- transferring certain responsibilities for setting position limits from the FCA to trading venues; and
- greater use of accountability thresholds in position management.

However, FIA members are extremely concerned about the FCA's proposed approach to the ancillary activities exemption ("**AAE**"), which is likely to be detrimental to the competitiveness of the United Kingdom and to the ability of UK entities to access commodity derivatives and forward contracts on emissions allowances (physically or financially settled), many of which they currently use for hedging purposes. Members urge the FCA to reconsider its approach and to reengage with HM Treasury as a matter of urgency to ensure that the FCA is empowered to make legally binding rules setting out the ancillary activities test ("**AAT**"). Members' concerns are more fully set out in our answers to Q1 and Q25.

FIA's response also includes comments on several other aspects of the FCA's proposals as currently drafted. These are addressed in the responses to the FCA's questions as listed below.

Q1: Taking into account the proposals outlined below, do you have any specific comments regarding implementation of the new regime? Please explain your answer.

Regarding this question, FIA members would like to focus on the timing – both for implementing the position limit regime and for introducing an appropriate replacement for the ancillary activities regime. We have additional implementation concerns on other areas of the proposals, such as the scoping and implementation of OTC reporting. Those concerns are set out throughout our response.

<u>Transitional Period</u>

The FCA proposes a transitional period of one year to allow time to make the necessary changes to comply with the regime. With regard to the proposals relating to implementation of position limits and position management controls by trading venues, FIA members would like FCA to confirm their understanding that the proposed one-year transitional period refers only to the period for trading venues to implement rules to comply with those proposals. Assuming this is the case, FIA members note that:

- This is an aggressive timeline, given that each trading venue will need to develop a significant number of rules changes, ensure it has gone through appropriate internal governance, and give the market sufficient time to comment on the changes prior to the rules' finalisation. FIA members are of the view that this is not achievable within a one-year period.
- Market participants will then not be able to start implementation of changes to their systems and processes until those trading venue rules are known. FIA members suggest they might need an additional period of at least 6 to 9 months to adjust to the new trading venue rules in relation to position limits, position reporting and position management controls. Market participants that are not regulated firms will also require time sufficient for review of the new venue rules to determine whether reliance on exemptions is necessary.

PERG Guidance

FIA members wish to emphasize that the timing for firms that currently use the AAE is critical**.** The current AAE falls away on 1 Jan 2025, and unless it is replaced by a new regime which provides legal certainty, firms that currently rely on this exemption and their counterparts will be reluctant to enter into transactions with a maturity beyond 1 January 2025. This is already becoming an issue for members when considering the legal risks associated with longer-term transactions. This issue will become more of an impairment to normal operations as 2024 progresses.

The FCA's proposed guidance does not address the issue of legal certainty previously raised with the FCA and HM Treasury by trade associations and market participants, not just for those firms that will now fall outside the AAE but also for those that expect to be able to fall within the new version of the AAE applicable from 1 January 2025.

Any delay in consulting on, or implementing, such a regime (noting the fact that the FCA has indicated that its final guidance will only be made available in the second half of 2024) will make the proposed change to the AAE very challenging, if not impossible to manage. For firms that will not be able to rely on the AAE there may be insufficient time to obtain the necessary FCA authorisation by 1 January 2025.

This could result in those firms conducting unauthorised investment business and risk the contracts that they enter into that have effect beyond 1 January 2025 being voidable.

Even the simplest of authorisation applications can take at least 6 months to prepare, not least as the firms seeking authorisation will have to comply with the IFPR/MIFIDPRU capital regime. FCA's 6-month time period to consider an application only begins to run when the FCA considers the application complete. As such, even assuming that the FCA had no further questions on an application, a firm would need to prepare its application at the beginning of Q2 2024 for submission by 30 June 2024. This is before the PERG guidance is expected to be published in final form. Any investment activities or services conducted by firms after 1 January 2025 without authorisation would be in breach of the general prohibition and, as such, constitute a criminal offence and be potentially unenforceable against counterparties. Even if the FCA was to issue some form of no action statement for such firms, this would not mitigate the risk of unenforceability of contracts. The FCA will appreciate the risk of market disruption this may cause.

FIA members realise that a change in timing and a change of approach to make legally binding rules would require changes to legislation and would urge FCA to engage with HM Treasury to amend the date when the current ancillary activities exemption falls away until an appropriate period after the new rules are in place and allowing for an appropriate period for firms no longer benefitting from the AAE are able to obtain the appropriate authorisation, and for HM Treasury to provide rulemaking powers to the FCA.

Please refer to FIA's response to Q25 below for further details.

Q2: Do you agree with the approach outlined, including the criteria to assess the criticality of contracts? If not, please explain why.

FIA members agree in principle with the approach to move away from the setting of limits for all commodity derivatives to focus on critical contracts and directly related contracts necessary for the objectives of the regime. FIA appreciates that the proposed regime provides more flexibility to react to changing market conditions and external events.

However, FIA members have several concerns about the process proposed by FCA to determine whether a contract is critical, which are set out below.

<u>Assessment Process</u>

The consultation paper and draft MAR 10.2.1B G list a number of factors (all of which seem appropriate). However, there appears not to be an obligation on the FCA to set out how the contract was assessed against the factors listed. Such information would be useful, especially, if, FCA agrees to take comments from market participants, as suggested below.

<u>Consultation Process</u>

There appears not to be any process or opportunity for market participants or trading venues to provide input on this assessment of criticality and the appropriateness of the criteria used by the FCA. According to para 3.39, the only consultation process arises when the FCA has *already* determined that the relevant contract amounts to a critical contract.

FIA members understand FCA considered the option of prior formal consultation and rejected it on the basis it may be difficult to update the list in a timely manner, where relevant markets are changing quickly (para 3.25). That may be so in some cases, but it does not seem appropriate to cater for the exception rather than the rule. FIA members consider consultation imperative. The rules should require FCA to consult unless such market conditions prevail which demand an immediate response, in which case FCA could add the contract to the critical list for a limited period, and then consult to see if the addition should be maintained.

FIA members also recommend that there is a periodic assessment of the contracts listed on the register of critical contracts, to ensure that the appropriate contracts are in scope.

<u>Protection Provided by Other Regulators</u>

Finally, if a contract is already monitored by a trading venue or market regulator in another jurisdiction and subject to position limits under another regime (for example, the WTI contract), consideration should be given to the role of the authorities overseeing the primary market where the greater volume of trading is concentrated. Despite fulfilling the other criteria of being a "critical contract", such a contract should not fall under a duplicative position limit regime established by the FCA.

Q3: Do you agree with the approach outlined above with respect to related contracts? If not, please explain why.

FIA members agree in principle that certain related contracts should be considered in the process by which trading venues' set position limits. However, FIA members believe that the current criteria are too prescriptive and that not all contracts that come within the wide criteria currently set out in the draft rules should be included.

Purpose

Related contracts should only be included if, in the view of the relevant trading venue, they might be used to try to manipulate a critical contract or capable of impacting the supply or demand in the commodity that is delivered into the critical contract. FIA members are of the view that this purpose should be clearly set out in the operative provision at MAR 10.2.1A(3) R.

Definition of "Related Contract"

FIA members believe that the proposed definition is too wide:

- As proposed, it covers any commodity derivatives contract traded on a trading venue in the UK that meets one of three conditions (see our comments regarding the conditions further below).
- "Commodity derivatives contract" is defined by reference to provisions originating from MiFID and MiFIR, and therefore includes structured products referencing commodities.
- Further, the phrase "traded on a trading venue in the UK" does not refer back to the trading venue on which the critical contract is traded (in FIA's terms, the "primary market") so it is conceivable that a contract traded on an OTF or MTF, which is meeting one of the conditions, would have to be included in position limit established by the primary market.

FIA members also consider that the three conditions are too widely cast in order to deliver the objectives of the regime, and the conditions should be limited in application to contracts that could be used in conjunction to manipulate the critical contract.

The first condition stated by FCA is that the settlement price of the related contract be linked to the settlement price of a critical contract. The implication of this condition is that both contracts based on indices including the critical contract's settlement price and commodity spreads would be "related contracts". FIA members agree with the established assessment of the CFTC that these contracts are unlikely to be capable of being used to manipulate a critical contract and that consequently they should be explicitly excluded from the definition of related contract. More specifically:

- Contracts based on indices published by price sources which include one or more critical contracts should be excluded from the definition.
- The category "Inter-contract spreads that include a critical contract" alone has the potential to complicate implementation considerably given the number of spread products listed on relevant trading venues (for example, contracts containing a Brent element listed on ICE). There is a risk that the proposals would result in a regime which is much more restrictive and more complex than other regimes internationally, and so may impair international competitiveness. As an example, the CFTC position limit regime explicitly excludes location basis contracts, where one leg of the contract is a commodity that is subject to the CFTC position limits regime and the other leg is not subject to the regime.

The third condition brings into the definition of related contracts those commodity derivative contracts with the same underlying as the commodity underlying the critical contract. FIA members recommend that the definition should be refined so as to refer not only to the same underlying commodity but to the same specification as that of the critical contract.

<u>Position Calculations</u>

Finally, the FCA suggests at 3.34 of the Consultation Paper that trading venues might not prescribe the netting of related contracts. This is problematic. If related contracts are not included in the position calculation in the same way in all cases the regime may be administratively burdensome, over-complicated and entail significant implementation and ongoing operational costs. This could also lead to longer timelines to implement operational changes required in connection with the classification of additional critical contracts.

Q4: Are there any specific types or classes of contracts that should not be included in the related contract concept? If so, please explain why.

As set out above, FIA members question the scope of the related contract concept. As presently drafted, the definition is very wide, potentially covering a large number of contracts. Related contracts should be included only if they could reasonably be used to manipulate a critical contract.

Contracts that are already subject to position limits under another regime (for example, ICE Futures Europe has CME lookalike contracts that are subject to CFTC limits) should not be subject to additional limits under the UK regime.

<u>New contracts</u>

FIA members also recommend further consideration as to the implications of the proposals on introduction of a *new contract* which would automatically qualify as a related contract. Such a contract would require flexibility to acquire the liquidity it needs to develop and survive. The current regime had an exception for new and illiquid contracts for this reason. FIA members suggest either to retain such exemption for the inclusion of related contracts under the new regime, or to provide for an alternative form of exception whereby such new related contracts are only subject to position limits after an implementation period or of a certain number of months, or after the related contract has grown to exceed a specified volume of open interest. FIA members consider that the precise approach should be determined on a case-by-case basis by the exchange in line with the response to Q3 above.

<u>Notification</u>

The FCA expects a trading venue to provide it with prior notification of its position limit framework, including "the proposed list of related contracts, related OTC contracts and related contracts traded on overseas trading venues". Trading venues will also have to publish "in a clear and accessible manner the list of related contracts for each critical contract." FIA members therefore believe that in the interests of transparency and market stability the FCA should establish an obligation on the trading venues to notify market participants on the addition of any related contracts before they are included in the position limit regime, if practicable in the relevant context and circumstances, with the capability for feedback to be given on the appropriateness of the categorization as a related contract. The proposed process in relation to critical contracts might also be adopted here.

Q5: Do you agree with the proposed approach to update the list of critical contracts? If not, please explain why.

The FCA proposes to give market participants a 45-day notice period in which to provide comments, and a further 30-day implementation period for trading venues to establish and apply a new position limit. FIA members believe that these notice periods are too short. In particular, there is concern:

- that the 30-day period does not allow enough time for the trading venue to develop a methodology using the various criteria proposed by the FCA, to consult with market participants on its rule changes, and to provide market participants with sufficient notice before applying the new limit;
- about the lack of any implementation period for market participants that may hold existing positions in excess of the new position limit prior to its introduction. FIA members consider that an additional implementation period should be granted for market participants so that positions exceeding a new limit can be unwound in an orderly manner, otherwise there may be a negative impact on volatility; and
- that the short notice period from the FCA declaring a contract to be critical to the trading venues having to implement position limits may contribute to disorderly markets. If the FCA informs the market that it considers a contract critical and a position limit will apply in 75 days' time, but the level of that limit is not signposted in advance, this is likely to lead to market uncertainty as to what limits will apply, with negative pricing impacts on that contract (as market participants may seek to reduce positions).

In view of the above, FIA members recommend that the 45-day notice period could remain as is, but the 30-day implementation period should be extended to a minimum of 90 days or longer, depending on the relevant trading venue's assessment. A simple limit applied to an individual contract can be implemented relatively quickly compared to a contract with daily deliveries and multiple linked contracts. Therefore, it is important that there should be some flexibility for consideration to extend the implementation period to beyond a 90-day implementation period.

Q6: In notifying us of a particular market that requires closer monitoring, are there any other factors that trading venues should consider? If you think there are, please explain what the additional factors are and why they should be considered.

FIA members have not identified any additional factors.

Q7: Do you agree with the list of critical contracts above? If not, please explain why.

FIA members are broadly in agreement with the proposed list.

However, FIA members question the inclusion of WTI in the list of critical contracts. A CFTC position limit already applies to WTI in the US and the application of a UK limit would lead to the contract having several limits under two regimes. As a Foreign Board of Trade under the CFTC regime, ICE Futures Europe is already required to impose the same position limits on the WTI Futures Contract as the relevant US Designated Contract Market (CME), so requiring IFEU to impose additional limits under the UK regime would be duplicative. The outcome for IFEU's WTI Futures Contract would be as follows:

- IFEU spot position limit for the duration of the entire month;

- CME-equivalent position limit for the last two trading days prior to expiry;
- IFEU spot accountability level for the duration of the entire month;
- CME-equivalent single month accountability level;
- IFEU position limit for all other months;
- IFEU accountability level for all other months;
- CME-equivalent accountability level for all months.

For a similar reason of avoiding duplication, FIA members believe that the UK regime should not require critical contracts to have mandatory spot accountability thresholds (although a trading venue may elect to apply such on a discretionary basis) or other months to have position limits.

FIA members understand the FCA may be concerned that no position limit would apply to WTI if the CFTC removed the position limit. However, it is noted that the proposed process for adding new critical contracts could be used to establish a position limit for this contract later, should the need arise.

Q8: Should any of the three cash settled contracts mentioned above (Dated Brent Future, Dubai 1st Line Future, Singapore Gasoil (Platts) Future) or the physically settled Permian WTI Future be added to the list of critical contracts? If yes, please explain why.

FIA members believe that such contracts should not be added to the list of critical contracts. Cash settled and cash-linked contracts have an infinite supply so tools other than position limits can be used to manage issues such as potential market abuse. The Permian WTI Future contract is not critical to the UK.

Q9: Taking account of our proposals on position management and the reporting of additional information, do you consider that the risks arising from positions held OTC are adequately dealt with despite the fact that position limits do not apply to OTC contracts? If not, please explain why.

FIA members agree that position limits should not apply to OTC contracts. Trading venues are already able to request relevant information on such contracts, where they feel that this is necessary to ensure market integrity of the contracts that they list.

Some FIA members wish to note that the consultation paper underestimates the costs and time needed for implementing an OTC reporting regime (for example, when OTC reporting was introduced for certain LME contracts, members experienced difficulties obtaining OTC information from clients).

Also, and more fundamentally, it has yet to be addressed what actions, if any, trading venues should take based on this OTC information. Therefore, should additional OTC reporting be contemplated, it should be limited to lookalike contracts that directly impact the integrity of a trading venue.

Further, some FIA members are concerned that if additional reporting requirements were applied to OTC client positions, the additional administrative work placed on the clearing member would be unduly onerous given the diverse nature of clients of the relevant trading venues and would result in significantly increased costs that would have to be passed along to end-clients using UK commodity derivative venues.

Q10: Do you agree with the approach and framework outlined above for setting position limits? If not, please explain why.

FIA members note that the framework affords a high degree of discretion to trading venues to set position limits. FIA members agree with the principle, but some are mindful that the relevant trading venues in this context (ICE Futures Europe and the London Metal Exchange) are commercial enterprises and are the only UK trading venues for their respective asset classes, and that the framework should therefore manage the conflict between their economic self-interest and their regulatory obligations.

As such market participants have an expectation that the FCA will ensure that the implementation and operation of the regime will be supported by robust information barriers between the market integrity and commercial areas of trading venues, and that anti-competitive behaviours (notably with regard to information gained by trading venues about market participants' activity on non-UK venues) is not used in any anti-competitive manner.

Q11: Do you agree with the criteria trading venues shall consider when developing their position limit setting methodology and when setting position limits? If not, please explain why.

In general, FIA members agree with the criteria to be used to establish position limits.

However, within the framework, MAR 10.2.1F G is very prescriptive as to the requirements for trading venues to adjust position limits upwards/downwards in certain specified circumstances. FIA members are mindful that this guidance may be interpreted by trading venues as a rule, and query whether it is consistent with the FCA's overall stated approach of giving trading venues the power to calibrate position limits on the basis that they are closer to the relevant markets and have more timely access to data and market intelligence. FIA members suggest that the language should be revised to refer to, for example, "should consider adjusting" rather than "should adjust" which implies an obligation.

FIA members have particular difficulty interpreting MAR 10.2.1F (3) and would appreciate clarification of the FCA's principle behind such adjustments of limits and whether it has a particular contract in mind to which this approach is intended to apply.

Q12: Do you agree with the approach to granting exemptions outlined above? If not, please explain why.

FIA members agree that trading venues should, in principle, be responsible for the hedging, pass-through and liquidity provider exemptions. They are closer to the markets than the regulator and are better placed to recognize the validity of exemptions claimed and granted.

<u>Expansion of the pass-through hedging exemption</u>

We are supportive of the introduction of a pass-through hedging exemption for financial firms. However, we suggest that FCA takes into account an additional scenario and recommend that trading venues should either grant a separate exemption to a financial firm, or expand the pass-through hedging exemption to apply to situations where financial firms enter into OTC or physical positions with a non-financial firm for the purposes of financing the non-financial firm (e.g. inventory monetisation), and the financial firm offsets the OTC or physical position by entering into an in-scope commodity derivative contract. Non-financial firms frequently look to monetise their physical inventory to fund working capital or capex and optimise liquidity.

The rationale for trading venues to grant such exemption is similar to that for the proposed pass-through hedging exemption: there are circumstances where non-financial firms may not be able to find a financial counterparty willing to enter into an inventory monetisation or financing arrangement because hedging such a transaction (i.e. taking title to physical commodity) would result in a breach of the applicable position limit for the financial firm.

Additionally, in the event that additional critical contracts become subject to position limits, financial firms may have no other alternative than to unwind these financing transactions with non-financial firms if no position limit exemptions are made available to these financial firms. This may cause unexpected liquidity issues for the non-financial firms relying on financing from financial firms.

As such, we suggest the FCA either expand the proposed pass-through exemption to capture the above situation or grant a separate exemption which would help facilitate non-financial firms' access to commodity-backed financing.

Exemption for firms in financial stress

FIA members suggest that a further exemption be added, in the form of an exemption for a person subject to position limits which is in a distressed financial situation as a result of the insolvency or bankruptcy of a client or affiliate. This is an exemption that would be called into use infrequently but would provide additional market stability at a time when forced transactions may lead to disorderly markets. FIA notes that such an exemption is available under the US position limits regime.

Exemption ceilings

FIA members would welcome additional background as to which risks the FCA is trying to control by introducing exemption ceilings, as this concept is not familiar from the experience of other jurisdictions.

As a general comment, FIA members have an uncertainty around whether the proposed exemption ceilings will in practice operate as additional hard limits. This is further explained in the response to Q18.

FIA members would also appreciate more guidance as to how some aspects of the proposals regarding exemption ceilings would operate and the intended inter-relationship between them and other elements of the regime:

- trading venue operators are given discretion as to whether to impose such measures (MAR 10.2.5 R). FIA members are concerned over the inherent lack of certainty that this discretion creates in the operation of the regime in the absence of clear framing criteria;
- to determine the size of an exemption ceiling, trading venues are asked to consider various factors. However, it is unclear how the trading venue operator will conduct such an assessment (in particular with regard to the market participant's creditworthiness) and FIA members anticipate it may be very difficult for them to apply these factors in a consistent and non-judgemental way in practice; and

- the proposals appear to give trading venue operators *discretion* to determine when the size of a ceiling may be *amended*. FIA members believe that this too should be subject to due process, and as much notification given to the affected market participants as is possible.

With the power to grant position limits exemptions being moved to trading venues, there may be two exemptions on a contract, one monthly exemption from position limits and a separate exemption, for example from expiry limits. Each exemption may be granted using different criteria with one potentially being wider than the other. Notwithstanding indications from trading venues that they would seek to avoid such overlap, FIA members suggest that trading venues should be *required* to ensure current position management tools align with the FCA regime and do not result in overlapping regimes unless they are addressing a specific regulatory harm.

Q13: Do you agree with the approach to the hedging exemption outlined above and the information to be provided to evidence use of the exemption? If not, please explain why.

FIA members note that the FCA proposes to introduce a requirement that, when non-financial firms apply to the trading venue operator for an exemption, they must include information regarding their ability to unwind positions during times of market stress.

<u>Market stress:</u>

FIA members request that FCA provide further guidance as to why this requirement should be a condition for granting the exemption and how the information provided to trading venues should be assessed, bearing in mind that:

- applicant firms will have their own view as to what constitutes stressed circumstances in a particular market, which may be different to that of the trading venue. Notably, many of them will be unregulated and not familiar with the relevant concepts; and
- it will be challenging for trading venues to assess if and how a market participant would be able to unwind its position in a distorted/stressed market in the absence of knowledge of how other market participants may react. For example, in the case of a market participant in financial difficulties, different market impact may arise from a forced “fire sale” of positions into the open market versus a “trade sale” of the firm’s portfolio of positions to another market participant with sufficient resources to absorb it.

FIA members therefore advocate that the requirement for this information be deleted.

In the absence of deleting the requirement to provide information on the ability of a firm to unwind positions, FIA members suggest either:

- this requirement is not framed as a rule, or
- transparent and consistent criteria are established for the information that market participants need to provide in this context.

The alternative is that there is a risk that applicants may each formulate and apply their own criteria, resulting in additional workload both for themselves and for the trading venues that need to decide each application.

As stated above, it is not certain that trading venues would have all the information necessary to make this determination and this could lead to inconsistent decision making depending on the trading venue, market participant and timeframe over which action is expected to be taken. If necessary, and provided there is clear guidance, the trading venues may request the market participants to explain and clarify as appropriate.

Creditworthiness

Further, FIA members recommend deleting the requirement to assess an exchange members' creditworthiness. A trading venue would not readily have the relevant information available to conduct such assessment, as it is a criterion typically used by clearing houses, not trading venues.

Implementation

FIA members also wish to make a further point regarding the application of the proposals for non-financial firms who currently rely on the existing hedging exemption. Once the trading venues have established their new position limits, FIA members are mindful of the potential risk that market participants who entered positions under a hedging exemption granted to them by the FCA may need to unwind such positions until the trading venue grants them a new exemption (which would entail an increased market risk because of unhedged positions and a possible negative impact on volatility). The market participants may not want to unwind the whole position, especially in a stressed market. The issue is exacerbated by the short timeline from the FCA declaring a contract to be critical and the point by which a trading venue has to put in place the position limit (please refer to the response to Q5). FIA members would therefore be grateful if the FCA could confirm whether its expectation is that market participants will benefit from an implementation period to allow them sufficient time to apply for and obtain the relevant exemptions under the new regime.

Confidentiality

Given the commercial sensitivity of the information to be disclosed under MAR 10.2.8 R, FIA members call on the FCA to add to the requirements an obligation on trading venues to keep the information confidential to their market supervision teams and not to use it to secure an economic benefit to themselves or to disclose this other than to the FCA or to a court or according to any applicable laws and regulations.

Q14: Do you agree with the approach to the pass-through hedging exemption outlined above and the information to be provided to evidence use of the exemption? If not, please explain why.

FIA members support the introduction of a pass-through hedging exemption for financial firms but would wish to see more guidance on the information requirements.

Q15: Do you agree with the approach to the liquidity provider exemption outlined above and the information to be provided to evidence use of the exemption? If not, please explain why.

FIA members agree with the principles behind the proposed approach.

However, FIA members note:

- that there is no requirement established for the documentation of the obligation to be a liquidity provider. It may be FCA's intent that this criterion is determined by trading venues. This may give rise to insistent approaches and a lack of transparency over the awarding of exemptions to competing market participants.

- The proposal that applicants for the liquidity provider exemption provide details of the anticipated trading for the future year is contrary to the principles underlying a liquidity provider role. That is to react rapidly and continuously to market circumstances and client demand. The extent of this activity is almost impossible to predict, given the inherent uncertainty about future wars, earthquakes, elections, etc.

Q16: Do you agree that trading venues should establish accountability thresholds for critical contracts?

As a general comment, while FIA members agree with the purpose behind the proposed accountability levels, it is anticipated that in practice they risk operating as additional hard limits, given the additional reporting burden when exceeding the levels, as further expanded on in the response to Q18. This contrasts with FIA members' understanding that the FCA's intention here is only to provide an early warning system to alerts the trading venues to potential issues as early as possible.

FIA members would be grateful for further clarity as to whether the FCA expects the new accountability thresholds to apply in addition to UK trading venues' existing position management controls. It is noted that LME and ICE already have and operate accountability levels. With respect to LME, is it the FCA's intention that LME will adapt its existing regime to align with the proposed new rules? With respect to ICE Futures Europe, is it the FCA's intention that ICE Futures Europe will apply accountability thresholds in addition to its existing expiry and delivery limits?

FIA members note that the accountability thresholds apply to critical contracts and their related contracts. Similar points in relation to the scope of "related contracts" as were made in answer to the questions on the position limit regime apply here. FIA members wish to make two points regarding trading venues' powers to require a market participant to reduce its positions as per MAR 10.3.3A R:

- Many market participants use exchange traded derivatives to hedge their OTC positions. If a trading venue were to ask a market participant to reduce its exchange traded positions on the basis of that participant's reported OTC positions, the participant's unhedged exposure will increase. As it is more likely that accountability levels may exceeded in a volatile market (a larger ETD may be required to hedge against an OTC position as volatility increases), reducing on-exchange positions in such market conditions would further stress the market, increase the market risk and potentially the default risk of the individual firm being asked to become unhedged.
- The majority of FIA members believe the rule should clarify that UK trading venue operators may only take actions in relation to positions entered into on their relevant trading venue; it should not include "related contracts" on other UK trading venues, related OTC contracts, or related overseas commodity contracts.

FIA members propose to differentiate between spot and other months and to set position limits only on spot months, whereas for other months position management with the help of accountability levels would be used. There should also be flexibility provided to the trading venues to go beyond and establish accountability levels for spot months, if they consider this appropriate.

This framework would avoid creating two layers of thresholds applicable at the same time. Further, and especially close to the expiry date of the position, it does not appear to be sensible to have both position limits and accountability levels in effect. Where necessary, the trading venues could ask for further information on positions, risk management and delivery intentions. It is noted that the CFTC has mandated position limits only for spot months, whereas accountability levels are used for other months.

Many market participants may not currently have an OTC reporting system in place, and so FIA members are concerned that setting a requirement to report OTC positions to the trading venues will represent an additional burden and make the UK a much harder place from which to provide clearing services.

Finally, FIA members suggest amending the words "excessive or unjustified positions" in draft MAR 10.3.3A(c) R to instead read "excessive and unjustified positions". This change would clarify that the trigger is the breach of accountability thresholds, not a separate determination whether a position is unjustified without having regard to accountability thresholds. It also speaks to the intention of the regime, which is the preservation of market integrity and stability. The determination of an "excessive" position is inherently subjective and should be accompanied by a condition that some measure of inappropriateness is also present.

Q17: Do you agree with the approach outlined above and the factors that should be considered as part of the trading venues' accountability threshold setting methodology? If not, please explain why.

FIA members propose that the rules should require that trading venues review their accountability thresholds whenever there is a significant change to the relevant position limit or a change that significantly impacts the prescribed criteria, and in any case at least annually. This would assist in ensuring that the regime remains effective in meeting its objectives in the light of changing market conditions.

Q18: Do you agree with the set of conditions that result in the requirement to provide additional reporting? If not, please explain why.

FIA members anticipate that, the implications of triggering an exemption ceiling or an accountability threshold will be burdensome for market participants.

The additional requirements to report positions in related OTC derivatives contracts and contracts traded on overseas trading venues have a number of commercial and operational consequences. FIA members' concerns about these additional requirements are set out further in the response to Q19.

FIA members therefore perceive a risk that market participants will in practice regard such exemption ceilings and accountability thresholds as additional thresholds beyond which market participants do not wish to increase their positions, which may lead to markets operating inefficiently.

With regard to the proposals for accountability thresholds, the perceived risk described above is reinforced by the fact that it is proposed that trading venues must make an annual notification to the FCA and identify market participants who have exceeded accountability thresholds.

The overall effect is to present market participants with a more onerous regulatory environment, which may result in them opting to stay under the accountability threshold to avoid potential additional reporting. This may affect liquidity or lead to any additional trading to go OTC so as to avoid the limit. Either of these outcomes would harm the efficiency of trading venues and increase the risk of market volatility.

As mentioned in our response to Q16, FIA suggests applying position limits for spot months and use accountability levels for other months, but if FCA does not agree with this suggestion, then FIA members also consider that the threshold for additional reporting should operate net of any exemptions issued by the trading venue. As currently drafted, MAR 10.3.3 D R (1) suggests that position calculations should include "*any positions subject to an exemption under MAR 10.2*". This would mean that market participants benefitting from an exemption would be regularly triggering additional reporting when they are in fact simply executing the strategy they described when they first applied for and were granted an exemption. FIA members are of the view that if the exempted positions are included in this way, it will result in dialogue with the position holder which reiterates the original request for the exemption which would not be an efficient or productive dialogue. On the other hand, if the accountability level is assessed on the positions excluding exemptions, then there would be a much higher probability that the additional information would be meaningful to the trading venue in its supervision of the market.

Specifically on enhanced reporting, FIA members consider the FCA rules should enable a targeted approach to requesting OTC data rather than mandating exchanges to collect all related OTC data whenever an accountability threshold is reached/exceeded.

The OTC data differs in nature between commodities and the systematic collection of it does not support the exchange in developing a risk-based approach to position management (i.e. focusing on the OTC data that is relevant to the health of a critical contract). Some FIA members noted that an obligation to report additional information including OTC data based solely on rigid requirements rather than a risk-based assessment by a trading venue would be disproportionate.

Please refer also to the response to Q19 below.

Q19: Do you agree with the information to be reported once the additional reporting requirement is triggered? If not, please explain why.

It is noted that the information that is proposed to form part of additional reporting is set out at draft MAR 10.3.3E R, which provides that a trading venue operator '*may*' require the provision of the relevant additional information. FIA members wish to highlight that, in practice, trading venue operators already have the power to require provision of such additional information if they wish. The majority of FIA members suggest that FCA consider the proposed requirements of MAR 10.3.3E against the existing requirements of REC 2.7A.1. Having done so, the framework of rules should be recast to ensure that there is no duplication or ambiguity over the nature and extent of the requirements set.

FIA members infer (on the basis that draft MAR 10.3.3D R and MAR 10.3.3E R are framed as rules rather than guidance and noting the inclusion of the words "at least" in MAR 10.3.3E R that the FCA expects that trading venues not only 'may' but in fact 'must' require the provision of additional information in relevant circumstances.

The majority of FIA members are concerned about the mandatory nature of the proposal and would support the following amendments:

- Recasting MAR 10.3.3D R and MAR 10.3.3E R as Guidance rather than Rules
- Amending "must" in MAR 10.3.3 D R (1) (which mandates the collection of OTC data) to "may" which would be consistent with the language of REC 2.7A.1.

- Amending MAR 10.3.3D R (2) to provide exchanges with the flexibility to decide how long they need to collect the additional data, instead of a fixed criterion that reporting must continue until the position is below the threshold.
- Deleting “at least” from MAR 10.3.3E R (1) and providing venues with the flexibility to decide when and what additional reporting is required.

<u>Positions on overseas venues</u>

Some FIA members have **significant concerns** about introducing a formal requirement for market participants to report to trading venues information on their positions in related OTC derivative contracts. All FIA members expressed concerns regarding reporting to trading venues information on their positions in related contracts traded on overseas trading venues. FIA members consider some challenges arising from this requirement to be insurmountable.

First, as a general comment, the majority of FIA members question the proposals’ implication that there is fungibility between trading on UK trading venues, overseas trading venues and in the OTC market. FIA members disagree with any implication that activity on one market will have an immediate and negative effect on the market integrity on another market. This extends the concept of interdependency far beyond the existing interaction between competing commercial entities. FIA members believe that if such cross-venue risks pose a risk to market integrity, they should be managed by the respective regulators by, and between themselves. Additional specific considerations are set out below.

Secondly, FIA members also wish to point out that market participants may be restricted from providing such information to trading venues. In particular:

- As has already been noted above, ICE Futures Europe and LME are commercial undertakings rather than regulators. For trading venues, therefore, information about market participants’ activity in the OTC market and on other trading venues represents information about their competitors. There is a significant risk that market participants will breach:
    - competition/antitrust laws by reporting their positions on overseas trading venues to competitor UK trading venues; and
    - Confidentiality restrictions with respect to disclosure of information from clients.

  UK trading venues must be prevented from using such information (even on an anonymised basis) to secure an economic benefit to themselves.

- Market participants would need to conduct costly local law due diligence. FIA members are aware that in certain countries, market participants will be in breach of local regulatory requirements by reporting positions without the permission of the relevant overseas regulator or for that matter, under the trading contract with their clients. The latter objection could be overcome with contractual amendment, but that would involve expensive repapering of clients.

UK trading venues should not be able to routinely require position data regarding positions from other trading venues with whom they are in direct competition. If this cannot be avoided, FIA members suggest that the FCA requires that trading venues have effective information barriers between their regulatory and commercial sides and that reported data is not used to secure an economic benefit to themselves or passed outside the market surveillance area.

Practical Considerations

In addition to the legal and commercial restrictions outlined above, FIA members note that the proposals do not prescribe a particular format for reporting additional information (or for sub-sets of additional information, such as related OTC contracts). As a result, if trading venues were to implement differing format requirements, market participants would need to build different systems in order to comply.

It is also to be noted that the LME's OTC reporting regime applies to LME members and affiliates, whereas the FCA proposal would go beyond this and include clients of the clearing members within its scope.

Clearing members may not have any means to obtain such information from clients with whom they do not have any contractual or other relationship.

MAR 10.3.3DR and 10.3.3ER are drafted broadly and MAR 10.3.3ER(3) in particular defers to the trading venues to determine what OTC contracts are in-scope for additional OTC reporting following breach of an accountability threshold or breach of an exemption ceiling. FIA members believe it is FCA's intention that a trading venue member would only report a client's OTC position if they were the counterparty to that transaction. However, given the ambiguity in the drafting, the FCA/Trading Venue could potentially require a clearing member firm that acts as executing/clearing broker for the client to also report OTC positions for their clients where the clearing member firm is not counterparty to the OTC trade. This would require the clearing member firms to seek details of the client's OTC positions with third parties, including other members of the trading venue.

FIA members believe this would be very challenging to implement – especially since this would result in duplicative reporting (where the client's counterparty is a member of the trading venue. In addition, there could be competition issues with a client sharing with its clearing broker an OTC position the client holds with third parties. We therefore suggest clarifying the wording that any enhanced reporting would only apply to clients, where the clearing member is a counterparty to the OTC transaction.

In any event, this is very likely to be a burdensome process, resulting in increased operational complexity and compliance costs for market participants and their clearing members, and so damaging the international competitiveness of UK trading venues and the UK financial sector.

Conclusion

For the reasons set out above, the majority of FIA members disagree with the current proposals on additional reporting and would recommend instead adopting an approach similar to that practiced in the EEA under MiFID2 and in the US, whereby trading venues have the ability (but not the obligation) to require clarifications or additional information as part of their position management process. This would also decrease the risk of market participants avoiding UK trading venues for reasons of having a more onerous regulatory framework and trading partners avoiding entering into OTC transactions with counterparties that are a member of a UK trading venue and thus subject to the proposed rules. Such consequence would negatively impact both the ETD and OTC commodity market. The majority of our members believe adopting our suggestions in response to Q19 would assist the FCA to promote international competitiveness in accordance with its objective.

That said, given recent market disruptions, there is some support among FIA members for appropriately proportionate enhancement of OTC reporting and the FIA is aware that one venue will require regular OTC position reporting.

Q20: Do you agree with the definitions of related OTC contracts and overseas contracts? If not, please explain why.

The majority of FIA members agree with the proposed approach on a technical level. However, FCA should refer to our response to Q19 above for consideration of the significant flaws that will arise should these definitions be implemented in an inappropriate framework.

Q21: Do you consider that additional reporting requirements should apply at a group level rather than entity level for the reasons highlighted in paragraph 6.33 above? If not, please explain why.

FIA Members had differing views on this.

The majority of FIA members do not agree that additional reporting requirements should apply at a group level, as it would be burdensome and disproportionate to have to obtain information from affiliates. FIA members note that information on OTC derivatives transactions may also already be reported to the FCA under UK EMIR. Some FIA members would like clarity on the definition of “Group”.

Having the requirement to report at a group level, and exposing the whole book at the group level even if a small UK entity exceeds the accountability threshold would disincentivise market participants from using the UK trading venues and negatively impact the commercial competitiveness of the UK.

Q22: Do you agree with the proposal for trading venues to develop a periodic market risk analysis report? Please explain your answer.

FIA members have no view on this question, as it is a matter between trading venues and the FCA.

Q23: Do you agree that trading venues are best placed to determine for which contracts CoT reports should be published or do you have views on how the criteria should be amended? Please explain your answer.

Yes. Current CoT reports do not provide meaningful transparency and the categorisation of clients is unclear and consequently misleading. Therefore, FIA members would support a revised COTR framework.

Q24: Are there any other changes to the public reporting of aggregated positions that you consider appropriate? If yes, please explain the changes you propose and why they are necessary.

FIA members have no proposals in this area. It is believed that any such changes should be a matter for trading venues and their market participants, implemented after sufficient consultation.

16 February 2024

Q25: Do you agree with the proposed guidance on the AAT? If not, please explain why.

No , FIA members do not agree with the proposed guidance.

<u>Legal certainty</u>

- FIA members need to be able to rely on the legal validity of transactions entered into when relying on the AAT. There is a significant concern across the FIA membership that providing guidance in PERG is insufficient to ensure legal certainty under English law, for example in a bankruptcy case when the validity of transactions will be analysed by a liquidator.

- The proposed guidance states that firms may "have regard to" the trading and capital employed thresholds in the EU delegated regulation, and FIA members would appreciate clarity as to whether this means that firms "can rely on" such thresholds; however, FIA's strong preference is for the AAE, including a reference to a de-minimis test, to have force of law as per our comment directly above.

FIA members believe that the current AAT proposals would put UK companies at a disadvantage to European/US counterparts and act as a disincentive for new UK market entrants.

If the FCA does not believe it has the legislative mandate to create legally binding rules with respect to the AAE, then FIA members request HM Treasury to urgently to make the necessary changes to give the FCA the required rule-making powers for the AAT so that commodities market participants have the necessary legal certainty beyond 1 January 2025.

FIA members have previously been told by HM Treasury as part of the industry roundtables and WMR consultation process that the legislation passed by HM Treasury was deliberately high level and that it was HM Treasury's intention to leave detailed rulemaking in relation to the AAT to the FCA, as the expert regulator.

This was specifically mentioned in the context of the AAE when market participants participated in a round-table discussion on the drafting of the legislation disapplying the existing AAE. Paragraph 7.10 of the Explanatory Memorandum to FSMA 2023 states: "HMT is committed nevertheless to ensuring that the FCA has the right powers to set any transitional provisions that may be necessary to deal with the situation in which a firm's trading activity can no longer be regarded as ancillary under the terms of the test, to preserve continuity and legal certainty."

The present situation is inadequate to deal with the legitimate concerns of market participants where the AAE is the only means of being exempt from the requirement to be authorised as an investment firm in the UK when trading as principal on own account or when providing investment services to customers or suppliers of their main business in commodity derivatives, emissions allowances or derivatives on them. The only definitive test that they can rely on to determine whether or not the AAE applies to them, i.e. the market share test, will be deleted from UK law on 1 January 2025.

As the business these market participants conduct amounts to MiFID investment activities or services, they cannot, as a result of Article 4(4) in the Regulated Activities Order (the "MiFID Override") necessarily avail themselves of the "with or through" exclusion in Article 16; commercial commodity firms conducting MiFID business thus need to rely on an exemption under the UK MiFID regime in order to not be required to be authorised as an investment firm.

It is vital for these currently unregulated market participants to have absolute clarity as to whether the AAE is available to them or not. If it does not then for these firms, from 1 January 2025:

- Conducting investment activities or providing investment services in commodity derivatives, emissions allowances or derivatives on them will be a criminal offence under Section 23 of FSMA and contravention of the general prohibition in Section 19 of FSMA. Counterparties could also be at risk of aiding and abetting if transacting with an unauthorised UK firm.
- The resulting agreements could be unenforceable (see Sections 26 to 29 of the FSMA). This applies to agreements entered into by persons who are in breach of the general prohibition and any agreement entered into by an authorised person if the agreement is made as a result of the activities of a person who is in breach of the general prohibition (as mentioned in PERG 2.2.2).

This has the potential to destabilise the UK commodities markets.

Impacted companies: FIA members suggest that the FCA refers to its own register of currently exempt firms that have notified the FCA of their intention to use the current AAE. This would provide further insights and information on the number and nature of firms who will be affected by such legal uncertainty. However, we note that the number of impacted market participants would be higher, as this list does not include international counterparties of the UK entity. The international counterparties indirectly rely on the UK entity being exempt to ensure enforceability of bilateral contracts.

The FCA's approach to enforcement is not the key issue here. This is about enforceability of contracts as no market participant wants to be in a situation where they have to go to court, in circumstances where (for example) an insolvency practitioner is arguing the technical legal point that a contract is not enforceable. Even if they were to lose the court battle, this could tie up resources and delay restitution for years on the insolvency of a counterparty.

There are potential negative impacts on the commodities market in the UK and this approach risks liquidity being affected and migrating away from the UK.

<u>De-Minimis Test</u>

In addition to the concerns raised regarding legal certainty, the lack of a de minimis test is problematic. Smaller and medium-sized firms in particular rely on this test as well as firms without a large physical asset base. Removing the Market Share Test without introducing an alternative would lead to smaller firms being disadvantaged, as they would no longer be able to rely on the AAE.

The EU's de minimis test sets a threshold of EUR3bn for cash-settled commodity derivatives contracts. The EUR3bn figure was taken from Art. 10 of EMIR (clearing threshold before the recent raise to EUR4bn in the EU). The reason for using a test similar to EMIR was that corporates are calculating their clearing thresholds already and since the EU's objective was to simplify the AAE, it seemed using a test already carried out by firms would fulfil this objective, although the calculation methodology had to be adapted to align with MiFID II. The purpose of the alignment was to avoid disadvantaging firms relying on different tests under the AAE, i.e. those relying on the new de-minimis threshold test and those relying on the capital employment test, the methodology for both tests is based on the same definition of netting and exclusions.

The FCA and HMT stated repeatedly that they did not want to change the scope of the ancillary exemption. The exclusion of the de minimis test contradicts this. It creates a problem for some firms and will require them to become authorised.

We believe adopting our suggestions in response to Q25 to a) implement rules instead of guidance and b) provide a de-minimis test, would assist the FCA to promote international competitiveness in accordance with its objective.

Q26: Do you have any other views on the points outlined above?

We note a typo in MAR 10; Art 10.2.1 B, in line 2, it should read contract instead of contact.

We also note references in draft MAR 10.3.3A R to accountability thresholds being “breached” rather than “exceeded”.

Q27: Do you have any comments on our cost benefit analysis?