MiFID 2: Commodity derivatives – scope

Key business impacts

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Summary

The revised Markets in Financial Instruments Directive (MiFID 2) and the new Markets in Financial Instruments Regulation (MiFIR) were approved by the European Parliament and European Commission in April/May 2014 and published in the Official Journal of the European Union (OJ) in June 2014. MiFID 2 and MiFIR will apply from 3 January 2018. The Level 1 legislation provides further mandates for the Commission to adopt a number of Delegated Acts, and for the European Securities and Markets Authority (ESMA) to develop draft regulatory technical standards (RTS) and implementing technical standards (ITS). Following several rounds of consultation, Level 2 legislation has been (or is in the process of being) adopted by the Commission and is due to be published in the OJ following a period of scrutiny by the European Parliament and Council.

This briefing provides an overview of the principal changes introduced in MiFID 2 and MiFIR in relation to commodity derivatives, emission allowances and derivatives of emission allowances[1]. It is one of two briefings on commodity derivatives under MiFID 2 dealing with (i) scope and (ii) position limits, management and reporting. In addition, we have recently published briefings dealing with (i) market structure, (ii) pre- and post-trade transparency, (iii) transaction reporting and (iv) investor protection.

The texts of MiFID 2 and MiFIR are of EEA relevance and hence will be applicable to non-EU, EEA countries once incorporated into the EEA Agreement. Whether MiFID 2 and MiFIR will continue to apply in the UK after the UK leaves the EU (Brexit), depends upon the future relationship of the UK and the EU. If the UK were to remain a member of the EEA following a Brexit, they would continue to apply; but in other scenarios, the UK would become a third country for the purposes of MiFID 2 and MiFIR, unless special terms were negotiated between the UK and EU.

If the UK becomes a third country for the purposes of MiFID 2 and MiFIR, UK firms are likely to seek to utilise the equivalence recognition provisions, where available. The FCA has confirmed that firms should proceed with the implementation of MiFID 2 and MiFIR, which would enable the UK to demonstrate equivalence if necessary.

[1] In this briefing, unless stated otherwise, we refer to commodity derivatives, emission allowances and derivatives of emission allowances collectively as ‘commodity derivatives’.

The use of the ancillary business exemption will be on condition that the person seeking to rely on it annually notifies the relevant competent authority and reports on request, the basis on which their dealing or investment services are ancillary to their main business.

Introduction

The expansion in scope of MiFID 2 and MiFIR to dealing in commodity derivatives has been one of the most significant and politically sensitive changes to the existing MiFID framework, and the Level 2 legislation that deals with commodity derivatives (RTS 20 on scope, RTS 21 on position limits and ITS 4 on position reporting) has been some of the most contentious. Indeed the European Parliament left leaning political groups only narrowly lost a vote in February 2017 that could have seen a rejection of some of the relevant RTS. On 28 September 2015, ESMA published its 'final' drafts of RTS 20 and 21. In April 2016, the European Commission notified ESMA of its intention to endorse the RTS subject to a number of amendments, including the addition of a capital-based test to determine whether a firm could benefit from one of the available exemptions. On 1 December 2016, the Commission adopted amended RTS. Both RTS await publication in the OJ, whereas ESMA has recently sent an amended ITS 4 to the European Commission for endorsement.

Key business impacts

- The exemptions available for firms trading commodity derivatives will be significantly narrowed. Any firm currently relying on an exemption in MiFID will need to consider whether it will remain exempt under MiFID 2.
- Spot emission allowances and all derivatives of them will be brought within scope.
- Firms will need to consider the broader consequences of becoming authorised investment firms under MiFID 2.

Exemptions from the scope of MiFID 2

MiFID 2 will significantly narrow the exemptions currently available to firms dealing in commodity derivatives to ensure that 'participants on commodity derivatives markets [are] subject to appropriate regulation and supervision'.

In order to remain exempt from the MiFID 2 regime, firms will have to come within the exemption in Article 2(1)(j) for firms dealing in commodity derivatives on an ancillary basis (the ancillary business exemption) or within the specific new exemptions in:

- Article 2(1)(e) for operators with compliance obligations under Directive 2003/87/EC establishing the EU Emissions Trading Scheme (the EU ETS Directive);
- Article 2(1)(n) for transmission system operators;
- (if adopted by the relevant member state) Article 3(1)(d) for entities that hedge commercial risks for local electricity undertakings and/or natural gas undertakings; or
- (if adopted by the relevant member state) Article 3(1)(e) for entities that hedge commercial risks for operators under the EU Emissions Trading Scheme.

Ancillary business exemption

MiFID 2 will modify the current ancillary business exemption under Article 2(1)(i) of MiFID. The current exemption is available to firms dealing on own account in financial instruments, or providing investment services in commodity derivatives to clients of their main business, on an ancillary basis where the main business of the firm's group is not the provision of banking or investment services. The exemption – now under Article 2(1)(j) of MiFID 2 – will be narrowed so that it will not be available (i) to firms trading commodity derivatives that deal on own account when executing client orders, or (ii) to any firm that uses high frequency algorithmic trading techniques, or (iii) to any firm whose group's main business is market making in relation to commodity derivatives.

The use of this exemption will also be on condition that the person seeking to rely on it annually notifies the relevant competent authority (CA) of such reliance and reports, on request from the CA, the basis on which they consider that their dealing on own account or providing investment services is ancillary to their main business.

The RTS set out the percentage thresholds for each asset class that a firm's speculative trading activity would need to remain below in order for a firm to rely on the exemption. The calculation would need to be performed for each asset class, and a firm need only cross one of the thresholds for the firm to fall outside the scope of the exemption.

RTS 20 sets out the criteria for determining when dealing on own account or providing investment services in commodity derivatives (together, commodities trading business) is to be considered ancillary for the purposes of this exemption. Broadly, firms will only be able to rely on the ancillary business exemption if their commodities trading business does not exceed specified thresholds. The RTS set out the two tests that have to be passed cumulatively to determine whether commodities trading business is 'ancillary':

- the 'overall market threshold' test, which compares the level of a firm's speculative trading activity in the EU in a certain asset class to the overall market trading activity in the EU in that asset class; and
- the 'main business threshold' test, which requires firms to determine (i) the extent to which their speculative trading activity in the EU constitutes a minority of their total trading activity at group level, or (ii) the extent to which the estimated capital employed for commodities trading business constitutes a minority of the total capital employed by the firm's group.

'Speculative trading activity' for the purposes of the overall market threshold test and the first methodology under the main business threshold test is calculated by aggregating the gross notional value of all contracts within the relevant asset class (for the overall market threshold test) or within all asset classes (for the first methodology under the main business threshold test) to which a firm is a party. It excludes all intra-group transactions that serve group-wide liquidity or risk management purposes[2], treasury financing transactions, commercial hedging transactions[3] and transactions entered into to fulfil obligations to provide liquidity on a trading venue (collectively referred to as 'privileged transactions'). In order to prevent one-off and periodic events from pushing a firm temporarily above or below a threshold in any one year, the calculation of the size of trading activities and capital referred to below will cover a rolling average of three years.

Thresholds have been set at different levels depending on asset class:

Oil and oil products: 3%

Gas: 3%

Metals: 4%

Agricultural products: 4%

Power: 6%

Coal:10%

Miscellaneous (eg freight rates): 15%

Emission allowances: 20%

The 'overall market threshold' test

For each commodity asset class set out in the RTS, this test compares the size of a firm's speculative trading activity to the overall market trading activity in the relevant asset class in the EU[4]. The rationale is that firms conducting a sizeable percentage of speculative trading in a particular asset class should be required to compete on a level playing field with other authorised market participants.

$$\text{\% for overall market threshold test} = \frac{\text{size of a firm's speculative trading activity in a commodity asset class in the EU}}{\text{size of the overall market trading activity in the relevant commodity asset class in the EU}}$$

The RTS set out the percentage thresholds for each asset class that a firm's speculative trading activity would need to remain below in order for a firm to rely on the exemption. The calculation would need to be performed for each asset class, and a firm need only cross one of the thresholds for the firm to fall outside the scope of the exemption.

[2] Intra-group transactions that serve group-wide liquidity and/or risk management purposes should be interpreted in line with Article 3 of the European Markets Infrastructure Regulation (EMIR). Under Article 3 of EMIR, the intra-group exemption can only be applied to transactions with non-EU affiliates where those affiliates are located in 'equivalent' jurisdictions.

[3] Activities that are deemed to be objectively measurable as reducing risks directly relating to commercial activity or treasury financing activity should be considered in a consistent way with EMIR, with the exception that for the purposes of MiFID 2 the definition would apply to all derivatives and not just over-the-counter derivatives.

[4] Calculated by aggregating the gross notional value of (i) contracts within the relevant asset class that are traded on EU trading venues; and (ii) other contracts within the relevant asset class to which any person in the EU is a party.

It is not clear to what extent there will be a reliable common source of market data to determine the overall market trading activity against which firms should compare their own speculative trading activity.

There is a further question on the effect of Brexit on the overall market threshold test. The percentage thresholds have presumably been calibrated on the basis of a commodities market that currently includes the significant UK market. Once the UK leaves the EU, UK trading activity would no longer be included in the calculation of overall market trading activity, which would reduce the size of the denominator in the overall market threshold test. Unless the percentage thresholds are adjusted to take account of the reduced EU market, this could bring smaller firms within scope of MiFID 2.

The 'main business threshold' test

In addition to falling below the overall market thresholds in each asset class, a firm's commodities trading business in all the commodity asset classes must account for not more than 10 per cent of the group's overall activity, measured by reference to either (i) total trading activity, or (ii) capital employed.

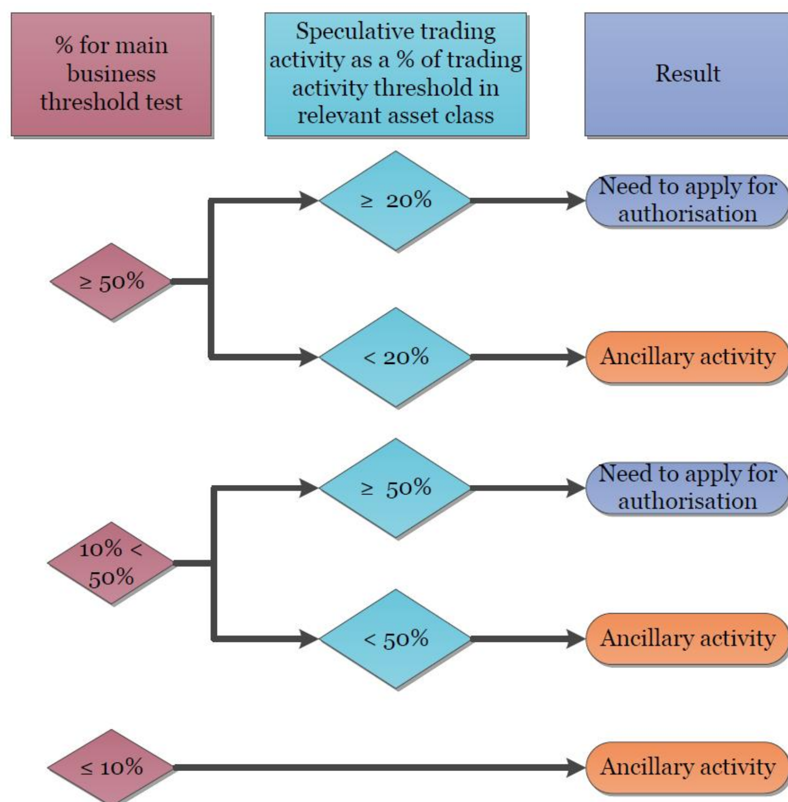
The size of the speculative trading activity in all the commodity asset classes must account for not more than 10 per cent of the group's overall activity.

(i) Total trading activity

$$\text{\% for main business threshold test} = \frac{\text{size of a firm's speculative trading activity across all asset classes in the EU}}{\text{size of the group's total trading activity in commodity derivatives}}$$

'Total trading activity' for these purposes is calculated by aggregating the gross notional value of all contracts in commodity derivatives to which persons within the group are a party.

The size of the speculative trading activity in all the commodity asset classes must account for not more than 10 per cent of the group's overall activity. If the speculative trading activity did account for more than 10 per cent of the group's total trading activity, a backstop test, under which the thresholds in the overall market threshold test are adjusted, would apply:



For example, if a firm's speculative trading activity is between 10 per cent and 50 per cent of the group's total trading activity, the threshold applicable to it under the overall market threshold test would be 2 per cent in respect of agricultural products.

(ii) Capital employed

$$\text{\% for main business threshold test} = \frac{\text{estimated capital employed for commodities trading business (excluding privileged transactions)}}{\text{capital employed in pursuit of a group's main business activity}}$$

For the purposes of this methodology:

... 'estimated capital employed'... is a metric derived from the Capital Requirements Regulation...

- 'estimated capital employed' (the *numerator*) is a metric derived from the Capital Requirements Regulation. It approximates the minimum amount of capital that would be held against the market risk related to positions in commodity derivatives (excluding privileged transactions). It is calculated as the sum of:
  - 15 per cent of each net position in a commodity derivative multiplied by the price of the commodity derivative; and
  - 3 per cent of the gross position in a commodity derivative multiplied by the price of the commodity derivative; and
- 'capital employed in pursuit of a group's main business activity' (the *denominator*) is calculated as the sum of a group's total assets minus its short-term debt, as reflected in the group's consolidated financial statements.

The capital-based methodology was omitted from ESMA's draft RTS in September 2015. In early 2016, the Commission proposed the reintroduction of this second methodology because a test based on trading activity may overlook significant capital investments by commodities firms in plants, infrastructure and machinery. The trading activity methodology is also ill-suited to groups that trade commodities for which there is limited or no liquid market to hedge the transactions. However, ESMA has raised concerns about the use of a capital-based methodology as it introduces significant complexity and the potential for firms to manipulate the test by changing the composition of their balance sheet.

Dealing on own account exemption

The ancillary business exemption... can be used in conjunction with the dealing on own account exemption...

The current exemption under Article (2)(1)(d) of MiFID for firms that do not provide any investment services and activities other than dealing on own account will be narrowed and will not be available in relation to dealing on own account in commodity derivatives. However, where a firm deals in a range of financial instruments, both the ancillary business exemption and the dealing on own account exemption will be relevant to consider.

The ancillary business exemption in Article 2(1)(j) can be used in conjunction with the dealing on own account exemption in Article 2(1)(d). This will mean that a firm that is exempt under Article 2(1)(j) in relation to investment activities and services in commodity derivatives should also be able to use Article 2(1)(d) to remain exempt for its dealing in other financial instruments, for example currency derivatives or interest rate derivatives as part of its treasury function.

The dealing on own account exemption will be narrowed under MiFID 2 so that it will not apply to firms which (i) are market makers; (ii) are members or participants in a regulated market (RM) or multilateral trading facility (MTF) or have direct electronic access (DEA) to a RM, MTF or organised trading facility (OTF); (iii) apply high frequency algorithmic trading techniques; or (iv) deal on own account when executing client orders. However, the exemption will still be available to non-financial entities who are members or participants of, or have DEA to, trading venues and execute transactions on such trading venues for hedging purposes relating to their (or their groups') commercial activity or treasury financing activity.

Other exemptions

The current exemption in Article 2(1)(k) of MiFID for firms whose main business consists of dealing on own account in commodities or commodity derivatives will be deleted. This will be a significant narrowing of the available exemptions.

MiFID 2 will include two specific new exemptions.

Article 2(1)(e) will provide an exemption for operators with compliance obligations under the EU ETS Directive, provided such operators do not execute client orders when dealing in emission allowances or derivatives of emission allowances and engage in no investment services or activities other than dealing on own account in emission allowances or derivatives of emission allowances. This exemption will not be available to persons who apply a high frequency algorithmic trading technique.

Article 2(1)(n) will provide an exemption for transmission system operators as defined in Directives 2009/72/EC and 2009/73/EC (the Directives dealing with the internal markets in electricity and gas) when performing investment services or activities in commodity derivatives to carry out certain functions, and any operator or administrator of an energy balancing mechanism, pipeline network or system when performing investment services or activities to keep in balance the supplies and uses of energy.

Optional exemptions

Member states will have the option to provide for new exemptions within their territory for commodity and emissions firms under Article 3 of MiFID 2.

Under Article 3(1)(d), member states may provide a specific exemption for entities providing services exclusively for the purpose of hedging commercial risks for clients that are local electricity undertakings and/or natural gas undertakings (as defined in the Directives dealing with the internal markets in electricity and gas). If adopted by a member state, this exemption may be available provided that (i) the service providers are, broadly, owned or controlled by the gas and electricity undertakings and (ii) such gas and electricity undertakings would be exempt under Article 2(1)(j) if they carried out the investment services themselves.

Article 3(1)(e) will provide a similar exemption for entities providing services for clients that are operators within the EU ETS Directive.

However, member states adopting these optional exemptions will be required to impose certain authorisation, supervision, conduct of business and organisational requirements analogous to those under MiFID 2 on firms relying on these exemptions.

...firms will need to consider the broader consequences of becoming authorised investment firms.

Consequences of losing exemptions

Firms no longer able to rely on an exemption under MiFID 2 will need to become authorised in order to continue trading in or providing investment services in relation to commodity derivatives which will be within the scope of MiFID 2 – see Financial instruments – commodity derivatives and Financial instruments – emission allowances below. In addition, such firms will need to consider the broader consequences of becoming authorised investment firms. For example:

- regulatory capital requirements under the Capital Requirements Directive and the Capital Requirements Regulation apply to authorised firms (although commodity derivatives firms are largely exempt from the capital regime until December 2020);
- becoming authorised would mean that a firm's status under EMIR would change from a non-financial counterparty to a financial counterparty and the clearing, reporting and risk mitigation obligations under EMIR apply accordingly;
- firms authorised under MiFID 2 are classified as financial counterparties under the EU Regulation on securities financing transactions which requires financial and non-financial counterparties to report details of securities financing transactions (including repos, stock loans, buy-backs, margin-lending and similar transactions relating to securities and

commodities)[5] to a trade repository in the EU or to ESMA. A financial counterparty that enters into a securities financing transaction with a non-financial counterparty that qualifies as a small or medium sized enterprise will be required to report on behalf of that non-financial counterparty;

- the hedging exemption under the position limits regime would not be available to authorised firms as they would not be considered 'non-financial entities'; in addition, position reporting requirements applicable to investment firms would apply – see our separate briefing on position limits, management and reporting for further details;
- a firm authorised under MiFID 2 will be a 'supervised entity' for the purpose of the EU Benchmark Regulation. Under the Regulation, supervised entities will only be able to use[6] a benchmark in the EU if the benchmark is provided by an authorised EU administrator, or by a non-EU administrator where certain equivalence criteria are satisfied, or where the benchmark has been endorsed in accordance with the endorsement regime. Supervised entities that contribute to in-scope benchmarks will be required to comply with additional governance and control obligations and, where they contribute to critical benchmarks, can be required by regulators to continue submitting contributions for a period of up to one year extendable by a further year but not exceeding two years; and
- firms that become authorised or regulated in the UK will become subject to the Senior Managers' Regime, based on the UK government's plans to extend the regime beyond banks and insurers to all authorised firms in 2018. The extended Senior Managers' Regime would impose, amongst other things: (i) a 'duty of responsibility' on individuals at the senior management level allowing regulators to hold such persons accountable if things go wrong and, therefore, be able to take disciplinary action against them more easily; and (ii) an obligation on firms to annually certify the continuing fitness and propriety of its 'certified persons', which would broadly comprise of employees carrying on functions that may involve the risk of significant harm to the firm or any of its customers.

…the hedging exemption under the position limits regime would not be available to authorised firms as they would not be considered 'non-financial entities"

Financial instruments

Commodity derivatives

MiFID 2 will expand the range of commodity derivatives[7] within its scope. Commodity derivatives that can be physically settled are currently within the scope of MiFID if they are traded on RMs or MTFs. Under MiFID 2, such derivatives will also be within scope if they are traded on the new category of trading venue being introduced by MiFID 2, the OTF, unless they are wholesale energy products (as defined in the EU Regulation on wholesale energy market integrity and transparency (REMIT)) that must be physically settled (the REMIT carve-out).

There will be transitional provisions under which CAs will be able to exempt oil and coal derivatives which are traded on an OTF and must be physically settled (C6 energy derivatives contracts) from the clearing obligation and risk mitigation techniques under EMIR if they are entered into by non-financial counterparties or firms which will be authorised for the first time under MiFID 2. In addition, C6 energy derivatives contracts will not count towards the clearing threshold under EMIR during the transitional period.

[5] The definition of securities financing transactions is broad, but will exclude derivative transactions which are instead subject to EMIR.

[6] In this context, 'use' of a benchmark has a restricted meaning. A firm will only 'use' a benchmark if it is used as a reference in a financial instrument or financial contract, or if the benchmark is used to measure the performance of an investment fund.

[7] References in this section to 'commodity derivatives' exclude emission allowances and derivatives of emission allowances.

The European Commission's Delegated Regulation supplementing MiFID 2 regarding, among other things, defined terms for the purposes of MiFID 2 sets out further detail on the derivatives which will be subject to the REMIT carve-out and the C6 energy derivatives contracts that will be subject to the transitional provisions.

Emission allowances

MiFID 2 will bring within scope all emission allowances recognised for compliance under the EU ETS Directive.

In addition, all derivatives relating to emission allowances will be financial instruments under MiFID 2 irrespective of settlement method, trading venue or other characteristics.

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