# MiFID II

**Commodity derivatives**

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## Key Points

- An expanded range of commodity derivatives will be brought within the scope of regulation.
- Exemptions for firms dealing in commodity derivatives will be narrowed significantly .
- Mandatory position limits on firms dealing in commodity derivatives will be introduced, with an exemption for non-financial firms.
- A mandatory position reporting regime for operators of trading venues will be introduced.
- ESMA will have expanded powers of intervention in relation to position management.

## Expanded range of in-scope commodity derivatives

The range of financial instruments which are within the scope of MiFID II is broader than those covered by MiFID I. In particular:

- Emissions allowances and derivatives relating to them have been included in the list of MiFID II financial instruments.
- The MiFID category of financial instruments relating to options, futures, swaps and any other commodity derivative contract that can be physically settled provided that they are traded on a regulated market or multilateral trading facility ("**MTF**") has been expanded to also include such derivatives where they are traded on an organised trading facility ("**OTF**") (although wholesale energy products traded on an OTF that must be physically settled are excluded).[1]
- The existence of clearing arrangements are no longer an indicator of whether a derivative is a financial instrument and therefore within the scope of MiFID.

References in this briefing note to "**commodity derivatives**" include emissions allowances and derivatives relating to them.

## Removal and narrowing of key exemptions

MiFID I applies to commodity derivatives, but includes a number of exemptions. The exemptions available for firms which deal in commodity derivatives under MiFID II will be significantly narrower than under the current MiFID I regime. In particular, there is currently a significant exemption for persons whose main business is dealing on own account in commodities and/or commodity derivatives.[2] This exemption will no longer be available under MiFID II. Other key exemptions which were available under MiFID I in relation to commodity derivatives have also been rationalised, narrowing the scope of exempted activities. Firms trading in commodity derivatives which are currently outside the scope of MiFID because of an exemption will need to review their position to establish whether they will be within the scope of MiFID II or whether any alternative exemption is available.

Under MiFID II a specific "**ancillary activity exemption**" will be available where a firm's activities relating to commodity derivatives are ancillary to its main business, provided that the firm does not use high-frequency algorithmic trading techniques and does not belong to a group which has investment services or banking services as its main business (an "**Investment or Banking Group**"). A firm will be able to use this exemption if its activities fall within the following categories:[3]

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[1] The circumstances in which a contract should be considered one which "must be physically settled" are set out in ESMA, Final Report: Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014 (ESMA/2014/1569) (the "**Technical Advice**").

[2] Provided they do not belong to a group which has investment services or banking services as its main business.

[3] It is possible to use the MiFID II exemptions cumulatively, so a firm in this category may still be exempt where it also carries on other MiFID II activities which fall outside of these categories if another exemption applies in respect of those other activities.

- the firm deals for its own account in commodity derivatives but does not deal on its own account when executing client orders;[4] or
- it provides investment services in commodity derivatives (other than dealing for its own account) to the customers or suppliers of its own business.

Firms trading in commodity derivatives who are not currently authorised under MiFID will need to assess whether they can fall in the "ancillary activity exemption". This exemption is not available for any secondary trading activity.

Firms relying on the ancillary activity exemption must notify their national competent authorities ("**NCAs**") that they are relying upon the exemption and upon request must explain the basis in which they consider that the relevant activities are ancillary to their main business.

In order to qualify for the ancillary activity exemption, the activities relating to commodity derivatives must, individually and in aggregate, be ancillary to the main business of the firm's group.[5] The draft regulatory technical standard ("**RTS**") produced by the European Securities and Markets Authority ("**ESMA**")[6] proposed that a firm should consider its activities ancillary to its group's main business if:

- the size of its trading activity in commodity derivatives is within a certain proportion of the overall market activity in the EU in the relevant commodity classes (the "**market share test**"); or
- the firm's trading activity in commodity derivatives does not exceed a specified proportion of its main business activities at a group level (the "**main business threshold**").

The European Commission asked ESMA to revise the draft RTS to include a capital-based test for groups that have undertaken significant capital investments. The Commission subsequently adopted RTS 20,[7] which expands upon the criteria for assessing the main business threshold. Activities will be considered to constitute a minority of activities at group level where they comply with either of the following conditions:

- the size of the trading activities does not account for more than 10% of the total size of the trading activity of the group; or
- the estimated capital employed for carrying out trading activities does not account for more than 10% of the capital employed at group level for carrying out the main business.

RTS 20 sets out how the market share test, main business threshold and capital employed are to be calculated.

The market share test will be applied at an asset class specific level, with thresholds ranging from 3% (for derivatives on gas, oil and oil products) to 20% (in relation to emission allowances or derivatives based on them).

Although the main business threshold will be 10% in most cases, there is also a 'backstop' mechanism to ensure that the tests only capture the larger market participants:

[4] ESMA has expressed the view that the execution of orders in financial instruments between two non-financial entities directly and without any further intermediation by third parties as ancillary activity does not constitute "dealing on own account when executing client orders" and so activities of that nature should not prevent a firm from using this exemption.

[5] Commission Delegated Regulation (EU) of 1 December 2016 supplementing MiFID II with regard to RTS for the criteria to establish when an activity is considered to be ancillary to the main business ("**RTS 20**") states that firms or groups aiming to rely on the ancillary activity exemption will be required to calculate a simple average of the daily trading activities or estimated capital allocated to such trading activities for the figures of the previous annual calculation periods (1 January to 31 December) on a rolling basis to determine whether they fall above or below the relevant thresholds. However, the reference period for the calculation of daily trading activities or estimated capital allocated should comprise only the most recent annual calculation period if: (a) the most recent figures have declined by more than 10% when compared with the earliest of the three preceding calculation periods, and (b) the figures for the most recent calculation period is lower than the two previous calculation periods.

[6] The initial draft RTS were set out in ESMA's 2015 Final Report: Draft Regulatory and Implementing Technical Standards MiFID II/MiFIR, 28 September 2015 (ESMA/2015/1464), Annex 1.

[7] RTS 20, as defined in footnote 5 above.

- If a firm's trading activity in commodity derivatives is 10-50% of the total trading activity of its group, it is still exempted if its market share is less than 50% of the relevant threshold for the market share test (e.g. 1.5% for gas and oil derivatives and 10% for emission allowances and derivatives).

- If a firm's trading activity in commodity derivatives is above 50% of its total trading, it is still exempted if its market share is less than 20% of the relevant threshold in the market share test e.g. (0.6% for gas and oil derivatives and 4% for emissions derivatives, etc.)

The capital employed for carrying out the main business of a group is to be calculated as the sum of the group's total assets minus its short-term debt (that is, debt with a maturity of less than 12 months).

The estimated capital employed for carrying out trading activities is to be calculated as the sum of:

- 15% of each net position, multiplied by its price; and

- 3% of the gross position, multiplied by its price.

Positions can be excluded from the calculation of the estimated capital where they are:

- intra-group;

- entered into to fulfil obligations to provide liquidity on a trading venue; or

- objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity.

Criteria for determining whether a transaction is objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity are set out in the RTS.[8]

[8] See Article 5 of RTS 20.

## Position limits and position management controls

MiFID II will require NCAs to establish and enforce limits on the size of a net position which a person can hold at any time in commodity derivatives traded on a trading venue or economically equivalent over-the-counter ("**OTC**") contract.[9] Where the same commodity derivative is traded in significant volumes in multiple jurisdictions, the NCA of the trading venue where the largest volume of trading takes place shall set a single position limit which shall apply to all trading in the same contract. NCAs are required to notify ESMA of the position limits they intend to set, following which ESMA will publish an opinion and the NCA must either conform to ESMA's view or justify any deviation. ESMA may over-ride an NCA in certain circumstances: see the section below headed "Expanded powers of ESMA".

The position limits will not apply in respect of positions held by a non-financial entity ("**NFC**") which are objectively measurable as reducing risks directly relating to the NFC's commercial activity.[10] However, such positions will still be subject to position reporting requirements: see the section below on "Position Reporting". RTS 21 sets out criteria for determining whether a position qualifies as reducing risks directly relating to commercial activities and the procedure NFCs should apply to use this exemption.[11] Operators of trading venues on which commodity derivatives are traded will also be required to apply transparent and non-discriminatory position

[9] Article 6 of RTS for the application of position limits to commodity derivatives adopted by the Commission on 1 December 2016 ("**RTS 21**") states that an OTC commodity derivative contract is considered economically equivalent to a traded commodity derivative where it has identical contractual specifications, terms and conditions, excluding different lot size specifications, delivery dates diverging by less than one calendar day, and different post trade risk management arrangements. The RTS also defines the circumstances in which a commodity derivative can be said to be the same as another.

[10] Article 2 of RTS 21 also sets out a definition of 'non-financial entity' for these purposes.

[11] See Articles 7 and 8 of RTS 21.

management controls. These will include powers for the trading venue to:

- monitor participants' open interests;
- access information and documentation in relation to participants' exposures;
- require that positions be reduced or terminated; or
- require participants to provide liquidity back to the market on a temporary basis.

Operators of trading venues must provide details of these arrangements to their NCAs. NCAs will in turn notify ESMA, which will publish this information on its website.

Further detail in relation to the calculation of position limits is set out in RTS. NCAs will be required to calculate a baseline spot month position limit of 25% of the deliverable supply of the underlying commodity that can be used to fulfil the derivative's delivery requirement[12] for that commodity derivative, and then adjust the baseline to take into account the particular characteristics of that commodity derivative, the relevant underlying commodity market, and the commodity itself. For asset classes where there is no deliverable supply this baseline is by reference to open interest or the number of securities issued, rather than deliverable supply.

The RTS elaborates upon the factors to be taken into account by NCAs when adjusting the baseline position limit. In general NCAs are permitted to adjust from the baseline figure up to a limit of:

- between 5% and 35%; or
- between 2.5% and 35% for contracts where the underlying qualifies as food intended for human consumption with a total combined open interest in spot and other months' contracts exceeding 50,000 lots over a consecutive three month period.

A number of derogations from these limits can be applied in relation to new and illiquid contracts[13].

Position limits in the spot month for commodity derivatives with short maturity should be adjusted downwards from the baseline figure. For other months' position limits, where the commodity derivative has a large number of separate expiries, the baseline position limit will be adjusted upwards. that position limits in other months should be based on total open interest.[14]

## Position reporting

Trading venues will be required to make public weekly reports on the aggregate positions held by different categories of trader in relation to the different kinds of commodity derivative[15]. Trading venue participants will be required to report to the trading venue on their positions and those of their clients and so on until the ultimate client on a daily basis. The trading venue's weekly report will then be sent to the NCA and ESMA and made public. Venues will also have to submit a daily report to the national competent authority with a complete breakdown of the positions held by all persons on the venue. ESMA's December 2015 Final Report[16] set out revised draft implementing technical standards ("**ITS**") detailing the format and timing of these daily and weekly reports and breakdowns. These included some changes since previous drafts – for instance, it is now proposed that the reporting deadline for trading venue operators should be 17.30 CET on Wednesday of each week

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12 Articles 9 of RTS 21. Article 10 further specifies that the quantity of deliverable supply meeting this criteria is to be determined by reference to the average monthly amount of the underlying commodity available for delivery over the previous one year, taking into account storage arrangements and other factors that may affect supply.

13 See Article 15 of RTS 21.

14 Article 16 of RTS 21.

15 This requirement is triggered when the number of persons and their open positions exceed certain minimum thresholds. The applicable thresholds are set out in Article 83 of the Delegated Regulation of 25 April 2016 supplementing MiFID II as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of MiFID II (the "**MiFID II Delegated Regulation**").

16 ESMA, Final Report, Draft implementing technical standards under MiFID II, 11 December 2015 (ESMA/2015/1858) (the "**December 2015 Final Report**").

in respect of positions held as at close of trading hours on the previous Friday.[17]

ESMA recommended that the obligation for trading venues to produce weekly reports should only apply when both of the following thresholds are met:

- there are 30 or more open position holders existing in a given contract on the trading venue; and
- the size of the open position exceeds a level of four times the deliverable supply in the same commodity derivative.[18]

ESMA had stated previously that a "position" is "the net accumulation of buy and sell transactions in a particular commodity derivative, emission allowance or derivative on an emission allowance at a specific point in time that has yet to be closed out, expired, or exercised, as appropriate to the instrument concerned." ESMA also noted that an alternative definition of this term would be based on the concept of an "open interest" controlled by a person.[19]

Final ITS have not yet been approved by the Commission.

## Expanded powers of ESMA

ESMA will also have powers under MiFIR to request information from any person about the size and purpose of its derivative position or exposure. After analysing that information, ESMA may require the person to reduce or eliminate derivative positions (and also, as a last resort, may limit the person's ability to enter into commodity derivatives).

ESMA's position management powers are only to be used in emergency situations which the relevant NCA has failed to sufficiently address. In particular, the exercise of ESMA's powers must address a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the European financial system.

The MiFIR Delegated Regulation[20] sets out lists of criteria and factors for determining:

- circumstances which would justify the exercise of these powers by ESMA;[21] and
- the appropriate reduction of a position or exposure.[22]

## Timescales for implementation

The MiFID II Directive and MiFIR came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2018. The MiFID II Delegated Regulation and the MiFIR Delegated Regulation will also apply from the same date.

17 This is extended by one day if Monday, Tuesday or Wednesday are not a working day for the reporting market trading venue.

18 ESMA, Technical Advice, 19 December 2014.

19 ESMA, Discussion Paper: MiFID II / MiFIR, 22 May 2014 (ESMA/2014/548).

20 Commission Delegated Regulation (EU) of 18 May 2016 supplementing MiFIR with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions (the "**MiFIR Delegated Regulation**").

21 Article 22(1) of the MiFIR Delegated Regulation.

22 Article 22(2) of the MiFIR Delegated Regulation.

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