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MiFID II Wholesale Firms Conference
19 October 2015, ExCeL

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Breakout session: MiFID II and Commodities

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Agenda

- Where we are and what is next
- Pre-submitted questions
- Question and answers

Definition of "commodity derivative"

- The definition of "commodity derivative" is defined in Level 1 and has quirks in its perimeter that will challenge firms' and trading venues' implementation and ongoing compliance with MIFID2
- "Securities based on a commodity underlying" are **included**, although not shares nor bonds. This excludes the majority of commodity ETFs and ETNs
- Physically settled power and gas derivatives traded on an OTF will be captured under REMIT, not MIFID2.
- Clarification on "REMIT Carve Out" definition to be given in Delegated Act from Commission, expected December 2015

Ancillary activities

- Reminder: intention from co-legislators is to extend the scope of financial regulation
- The tests are two-way:
  - size of market share in a commodity class, and
  - size of speculative vs. hedging trading activity
- Thresholds are set by ESMA based on CBA data and are different for each asset class
- Firms must pass ***both*** tests in order to be exempt MIFID2

Ancillary activities (cont.)

- There are allowances for trades undertaken for hedging purposes, for intra-group transactions, and for certain liquidity providers
- The draft RTS submitted by ESMA permits:
  - Portfolio hedging
  - Proxy hedging
  - Anticipatory hedging
- **Firms that can clearly identify that they are not trading for speculative purposes will not require authorisation under MIFID2**

Position limits

- An entirely new concept at NCA level rather than trading venue level. Limits to be set and enforced for **all** commodity derivatives on all EU trading venues.

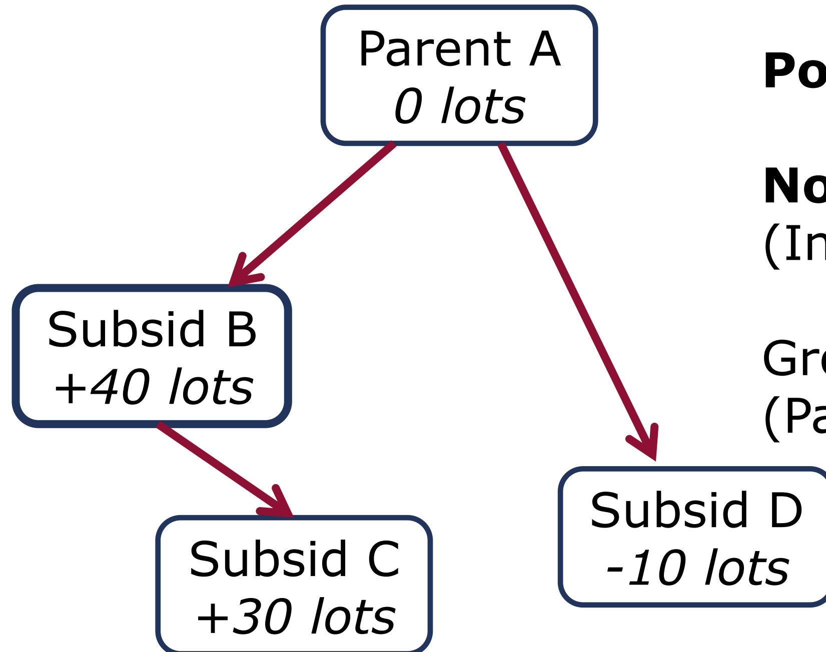
- The factors used to set limits are set out at Level 1, and the methodology to apply them is set out at Level 2.

- A de minimis regime is proposed for new and illiquid contracts to avoid damaging liquidity and innovative commercial activity.

Position limits (cont.)

- For non-financial entities, positions hedging commercial activities may be exempted from limits. No such exemption, either proprietary or “pass-through” is available to regulated firms.
- Includes “Economically Equivalent OTC Contracts”
  - “EEOTC” is determined by the persons entering into the OTC and appropriate classification will be checked by NCA supervision. A list of EEOTC contracts will not be published
- Netting: two buckets for Spot and “Other Months’” covers all expiries other than the Spot Month.
- Add together long and short positions, including ETDs, “Same” contracts and EEOTCs

Model for group aggregation



Position limit: 50 lots

No single entity in breach
(Individually: 0, 40, 30, 10 < 50)

Group **is** in breach
(Parent: 0+40+30-10=60)

All ownership relationships are 100%

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Position reporting

- The Level 1 requirements for reporting by trading venues and investment firms are extremely specific. We foresee many challenges, both operational and data privacy, with implementation in the manner intended by the co-legislators
- Reporting is done by *exchange members* to *trading venues* of their proprietary positions, and those of clients all the way down to the ***end client***
- Reports must identify (amongst other items):
  - the position holder
  - the ultimate parent entity
  - identify each position as hedging or speculative

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Other considerations

- These are specific issues for commodity derivatives.
- Other provisions of MIFID2 also apply as to other asset classes, such as **transparency**, **market-making**, **DEA** and **HFT** requirements.
- FCA and others are aware of industry concerns on "package trades" in the form of EFP transactions. Discussions are ongoing.

Pre-submitted questions

Question 1

- "What will the MiFID Implementation schedule look like for commodities firms who are newly subject to MiFID II ?

- Given the Ancillary Market Test is not clear and unlikely to be so until quite late on what timetable do the FCA expect to adopt.

- What will the prudential rule governing firms who trade in commodity derivative and are newly subject to MiFID II look like - are the rules likely to be re-evaluated and changed?

- What will happen to Firms who are not subject to MiFID II? Will the FCA still be super equivalent?"

Question 2

- "Will there be provisions in place for firms where their business model has changed considerably, resulting in the Trading Activity and Main Business Thresholds not being a true representation of current and future activity? Will such firms be able to be MiFID exempt based on their current and future activity?

- Will the start date move so that it is in line with threshold calculations, i.e. end of June beginning of July 2017?

- Will there be a phase-in period for firms to become authorised if they breach the thresholds, if so what are the timings?"

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Question 3

- “How does the FCA intend to recognise the differences when regulating financial and non-financial firms?

- For example, within the recent Thematic Review, parallels were drawn between the controls Investment Banks have in place to cover billions of pounds of trading and the controls commodity firms had in place to cover an activity that may well be ancillary to their day-to-day activities.”

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Question 4

- "How will a firm that meets the exemptions under Ancillary Activities be tested by the NCA that it has used sound methodology in coming to that conclusion and as a result does not require MiFID II authorisation?"

Questions?

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