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MiFID II: Commodity Derivatives and Emissions

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MiFID II is the latest piece in a package of European and global reforms impacting commodity derivatives and emissions traders, drawn up in response to concerns as to excessive speculation and volatility in the commodities markets and the integrity of emissions trading.

Introduction

This memorandum discusses commodity derivatives and emissions under the new Markets in Financial Instruments Directive ("MiFID II")[1] and the Markets in Financial Instruments Regulation ("MiFIR").[2] It is one in a series of client notes that will discuss the changes that the revision of the original MiFID will bring about from 3 January 2017.

Commodities and emissions trading firms will need to reassess whether they are now within scope as existing exemptions are significantly narrowed by MiFID II. A wider range of products, including emissions allowances, will also fall within the scope of financial instruments regulated under MiFID II. Hard position limits – which can apply to unregulated firms – will, for the first time, have to be imposed by national regulators and trading venues. National regulators will be empowered to require the reduction of positions in certain circumstances, and this will be supported by a new position reporting regime. Hedging activity by non-financial entities could fall outside the scope of MiFID II and positions reflecting hedging activity may also be exempt from position limits. The detail of how these reforms will be implemented in practice is considered in a consultation paper and discussion paper on the level 2 measures issued by the European Securities and Markets Authority ("**ESMA**"). ESMA is expected to consult on draft technical standards in late 2014.

1 Directive 2014/65/EU.

2 Regulation (EU) No 600/2014.

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Firms will need to consider the impact of MiFID II alongside other new legislation. All EU derivatives counterparties are subject to reporting obligations under the European Market Infrastructure Regulation ("EMIR"),[3] which also will bring in mandatory clearing of certain OTC derivatives, including for non-financial firms trading above the clearing threshold. To date, OTC commodity derivatives have not yet been proposed for mandatory clearing.[4] The EU market abuse regime has been reformed in parallel with MiFID II, so that a wider range of instruments, including emissions allowances, will also be within scope of the new market abuse regime.[5] For wholesale energy markets, including wholesale energy derivatives, the Regulation on Wholesale Energy Market Integrity and Transparency ("**REMIT**") sets out a parallel energy market integrity and transparency regime.[6]

Exemptions

Under MiFID, firms whose main business is to deal on own account in commodity derivatives are exempted from regulation. This exemption has been removed entirely in MiFID II.[7] It has been replaced by a narrower exemption for firms that deal on own account in (or provide investment services in relation to) commodity derivatives, emissions allowances or derivatives thereof, to customers or suppliers of their main business, if the activity is "ancillary" to their main business considered on a group-wide basis.[8] For the purposes of this exemption, the main business cannot be related to investment services, banking activities or market making for commodity derivatives, and the firm cannot be engaged in high frequency algorithmic trading. Firms that seek to rely on the exemption must notify their national regulator annually, indicating the basis on which they consider the activity to be ancillary to their main business.

The criteria for establishing when an activity is ancillary will be defined by ESMA in technical standards which should harmonise the scope of this exemption across the EU. The criteria will be based on: (i) the need for ancillary activities to constitute a minority of activities at group level; and (ii) the size of the firm's relevant trading activity compared to the overall market trading activity in that asset class. It is likely

[3] Regulation 648/2012. Our most recent publications on EMIR are available here and here.

[4] ESMA consulted on a clearing obligation for CDS and IRS earlier this year. On 1 October 2014, it published the final draft regulatory technical standards for IRS for consideration for adoption by the European Commission.

[5] Regulation 596/2014, which applies from 3 July 2016.

[6] Regulation 1227/2011.

[7] MiFID, Article 2(1)(k).

[8] MiFID II operators covered by the EU emissions trading scheme and transmission system operators may be exempt from the scope of MiFID II under Article 2(1)(e). In addition, optional exemptions may be available at national level in relation to joint venture companies jointly held by local energy utilities or operators covered by the EU emissions trading scheme (MiFID II, Article 3(1)(d) and (e)).

that the activities of both EU and non-EU entities within a group will be considered for the first test. Conversely, for the overall market activity test, the relevant trading activities will be those carried out by the entity in the EU. Firms that have a relatively high level of trading activity in comparison to authorised firms relating to non-hedging activities will need to become regulated, even if the relevant activities constitute a minority of activities at group level.

The amount of capital held in relation to the ancillary activity relative to the capital employed for the main business will be used by ESMA to determine whether it constitutes a minority (below 50%) of activities at group level. Certain transactions will be disregarded for the purpose of assessing whether activities are ancillary. These include intra-group transactions (as defined in EMIR) for group liquidity or risk management purposes, hedging transactions (meeting certain defined criteria) and transactions entered into in fulfilment of obligations to provide liquidity on a trading venue (such as, for example, market making requirements established by the UK energy regulator Ofgem or under the rules of trading venues).

For the overall market activity test, ESMA proposes to determine thresholds for various defined asset classes. These would operate in a similar way to the EMIR clearing threshold in that, once a threshold is breached for a single asset class, the activity would not be "ancillary." It is proposed that trade repository data available under EMIR and REMIT could be used to determine the level of trading activity. For this to be a viable option, the current obstacles encountered in reporting to trade repositories and issues on access to information held by repositories need to be ironed out.

Commodity firms that cannot make use of MiFID II exemptions will be regulated and, as a consequence, will not only be subject to the conduct of business requirements under MiFID II but to various requirements under other financial services legislation. These include capital requirements under the Capital Requirements Regulation ("**CRR**")[9] and the Capital Requirements Directive IV ("**CRD IV**").[10] However, commodity dealers falling within the scope of MiFID II are transitionally exempt from certain capital requirements under the CRR until 31 December 2017 if their main business consists exclusively of providing investment services or activities relating to commodity derivatives.[11] Becoming regulated pursuant to MiFID II will also impact on a firm's classification under EMIR. MiFID II investment firms will be financial counterparties for the purposes of EMIR[12] and as such will be unable to benefit from the EMIR clearing thresholds or hedging exemption available to non-financial counterparties.[13] A new MiFIR obligation to trade derivatives which are subject to the clearing obligation and sufficiently liquid on certain trading venues will also apply in full without being subject to a threshold.[14]

Financial Instruments

The range of both venue-traded and OTC commodity and emissions products covered under MiFID II is slightly broader than under MiFID.

[9] Regulation 575/2013.

[10] Directive 2013/36/EU.

[11] CRR, Article 498(1).

[12] EMIR, Article 2(8).

[13] EMIR, Article 10.

[14] MiFIR, Article 28.

Whereas MiFID only applies to emissions derivatives, the spot trading of units recognised for compliance with the Emissions Trading System Directive ("**ETS**"),[15] including European emission allowances and Kyoto carbon emission reduction credits, are within the scope of MiFID II. This means that commercial users of emissions allowances will need to ensure their activities in connection with such instruments only serve to hedge their physical emissions needs or otherwise allow the "ancillary exemption" to apply, if they are to avoid regulation.

In addition, physically settled commodity derivatives traded on the new organised trading facility ("**OTF**") venue type (as well as on regulated markets and multilateral trading facilities ("**MTFs**")) will be within the scope of MiFID II.

However, some carve-outs are provided. To avoid overlap with REMIT, wholesale electricity and gas contracts within the scope of REMIT that are traded on an OTF and that must be physically settled will not be financial instruments for the purposes of MiFID II. ESMA will also clarify the meaning of "must be physically settled" in technical advice.

A further transitional exemption is available for coal and oil derivatives which are traded on an OTF and which must be physically settled ("**C6 energy derivatives contracts**"), based on concerns as to the impact on prices and the functioning of these markets. At the discretion of the national regulator, C6 energy derivatives contracts entered into by non-financial counterparties and counterparties that will be authorised for the first time as investment firms under MiFID II can be exempted from the EMIR clearing obligation and margin requirements for uncleared transactions. Transactions in C6 energy derivatives contracts will not count towards the clearing threshold for non-financial counterparties until 2020. ESMA will publish a list of these derivative contracts on its website and has requested feedback on whether the exemption should include derivatives on refined oil products as well as crudes.

Separately, ESMA is currently consulting on draft guidelines on the definition of commodity derivative contracts under paragraphs C6 and C7 of Annex 1 Section C of the current MiFID, including the meaning of "physically settled."[16] Once finalised, these guidelines will harmonise the definition of C6 and C7 derivatives contracts (principally for the purposes of the clearing and reporting obligations under EMIR) until the entry into force of MiFID II.

Position Limits and Reporting

MiFID II introduces a new position limit and position reporting regime for commodity derivatives. The intention is to safeguard further against potential market abuse and to support orderly pricing and settlement conditions.

Position Limits

National regulators will be required to establish and apply position limits on the size of a net position in commodity derivatives traded on trading venues and economically equivalent OTC contracts. The limits will apply to the size of a position that a person can hold, including any other positions held on behalf of that person by group entities. ESMA proposes that positions of fellow subsidiaries of a mutual parent or holding company would not, however, need to be aggregated. A harmonised methodology for calculating the position limits will be set out in regulatory technical standards.

Position limits would not apply to positions of non-financial entities entered into for hedging purposes, but such positions will still be subject to reporting requirements (see below). The criteria for classification as a hedging position are likely to be consistent with the test used for the purposes of the EMIR clearing threshold.[17] ESMA proposes to

[15] Directive 2003/87/EC.

[16] ESMA/2014/1189.

[17] These are, essentially, contracts hedging risks either directly or indirectly associated with the normal course of business or contracts that qualify as hedging contracts pursuant to International Financial Reporting Standards.

apply the EMIR definition of "non-financial counterparty" to identify "non-financial entities." Firms will need to apply to their national regulator to make use of the exemption.

OTC contracts which are economically equivalent to commodity derivatives contracts traded on venues will be captured by the same position limits to prevent any circumvention of the restrictions. ESMA will develop criteria for determining whether a contract will be considered economically equivalent and has proposed two alternative approaches to this assessment. The first approach is based on setting out a number of factors that the contracts have in common, including risk profiles, maturities, deliverables, and margining and netting treatment. The second would be to refer to the approach taken by other jurisdictions, such as the proposed Commodity Futures Trading Commission ("**CFTC**") regime in the US. Under that regime, a contract is economically equivalent if it is a "lookalike contract" or linked or priced in relation to a specified contract or its underlying.

Where the same commodity derivative is traded in significant volumes on trading venues in more than one jurisdiction, a single position limit for that contract will be set by the regulator in the jurisdiction where the largest volume is based. For two contracts to be the same, they must be economically equivalent and also have other equivalent properties such as the same underlying deliverable.

Trading venues will also be required to apply position management controls, including:

(i) monitoring of open interest;

(ii) obtaining information about the size and purpose of a position entered into, beneficial or underlying owners, concert arrangements and any related assets or liabilities;

(iii) powers to require termination or reduction of positions; and

(iv) powers to require a person to provide liquidity back into the market at an agreed price and volume to mitigate the effect of a large or dominant position.

The MiFID II position limits regime is one of the broadest regimes of its kind globally and may impose a significant administrative burden on regulators. In the US, the controversial CFTC proposals to impose speculative position limits only apply to 28 physical commodity futures and option contracts and economically equivalent swaps. Many industry participants have commented that position limits are not always appropriate and could increase volatility by artificially interfering with supply and demand. Transactions in these wholesale markets are frequently very large and it is feared that the requirements could push trading away from Europe and damage liquidity. It has also been questioned why position limits should apply to cash settled contracts, when the potential to corner the market or create abusive squeezes arises mainly in relation to physically settled contracts. It is hoped that these issues can be mitigated by appropriate calibration of the level 2 measures.

Position Reporting

The position reporting regime is intended to support the application and enforcement of position limits. For the purposes of the reporting requirement, ESMA defines a "position" as the "open interest" controlled by a person. Trading venues will be required to:

(i) publish weekly aggregated position reports similar to those currently required in the US under CFTC rules ("**Commitment of Trader Reports**") for commodity derivatives, emissions allowances and derivatives on emissions allowances where the number of persons holding positions and the size of the positions exceed a minimum threshold.[18] The report must also be provided to the relevant national regulator and to ESMA, and will be published by ESMA; and

(ii) provide their national regulator with a complete breakdown of positions held by all members, participants and clients, on at least a daily basis ("**Position Reports to Regulators**").[19] To facilitate this, members or participants of trading venues (including when they are located outside the EU) will be required to report to the relevant trading venue their positions at the level of the ultimate client.[20]

Similarly, investment firms trading in commodity derivatives outside a trading venue will be required to provide their national regulator with a complete breakdown of positions, at the level of the ultimate client.[21]

Commitment of Trader Reports, and reports submitted by investment firms for "off-venue" transactions, must differentiate between hedging and non-hedging positions. All positions, long or short, will need to be reported on a gross basis. Position Reports to Regulators are likely to use a prescribed template similar to that used for transaction reporting under MiFID. Given that derivatives transactions are in any event required to be reported under EMIR, the value of a further bespoke reporting regime for commodity derivatives is questionable. Preserving client confidentiality is also a concern where chains of intermediaries are involved.

[18] MiFID II, Article 58(1)(a).

[19] MiFID II, Article 58(1)(b).

[20] MiFID II, Article 58(3).

[21] MiFID II, Article 58(2).

Regulatory Powers

In addition to their general enforcement and sanctioning powers under MiFID II, national regulators will have specific powers to require or demand the production of information regarding the size and purpose of a position or exposure under a commodity derivative and any underlying;[22] request the reduction of any position or exposure;[23] and to limit the ability of any person to enter into a commodity derivative, including through the position limits described above.[24] Under MiFIR, ESMA will have similar powers that can be used in cases where there is a threat to the orderly functioning and integrity of financial markets which relevant national regulators have not adequately addressed.[25]

22 MiFID II, Article 69(2)(j).

23 MiFID II, Article 69(2)(o).

24 MiFID II, Article 69(2)(p).

25 MiFIR, Article 45.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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