Sea of Change
Regulatory reforms – reaching new shores

MiFID2 and MiFIR: Commodity Derivatives

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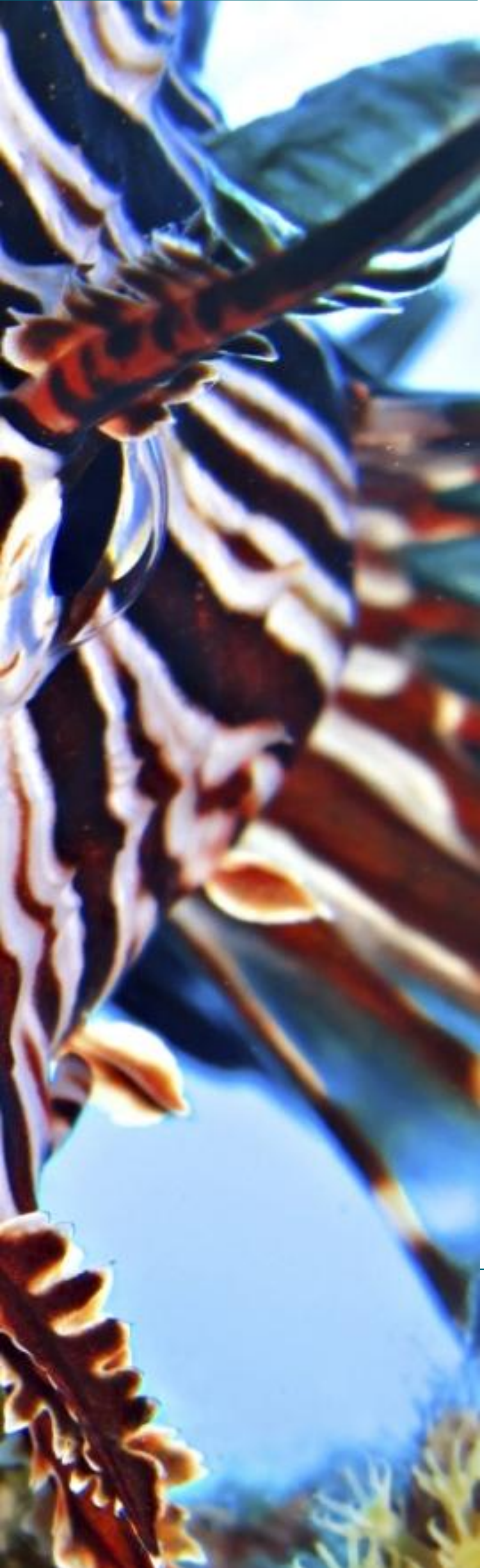
CLIFFORD CHANCE



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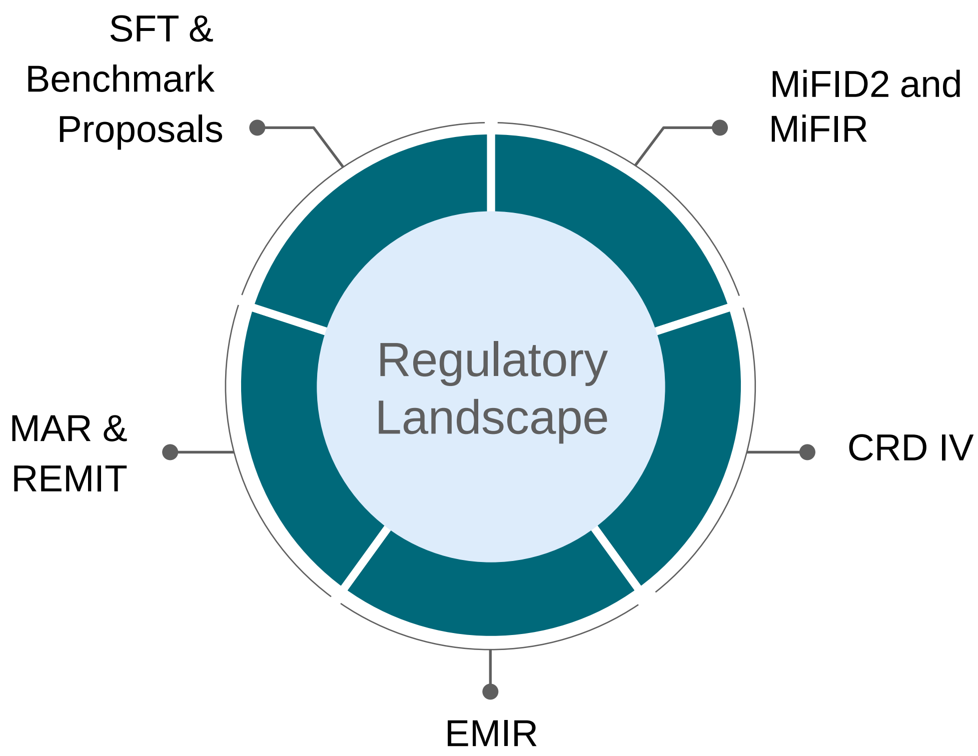
Commodities

Changing Regulatory Landscape

MiFID2 – Key Reforms

Scope and Categorisation	"Commodity Derivatives"
Licensing	Ancillary Services Exemption
Transparency	Liquidity Determinations
Restrictions	Position Limits
Information	Position Reporting
Powers	Position Management



What are “commodity derivatives” under MiFID2/MiFIR?

1. **Contractually based derivatives**	**Eligible underlyings**
Cash settled: Derivatives on eligible underlyings that are settled in cash or may be settled in cash at the option of a party (other than for default or a termination event) **Venue traded:** Derivatives on eligible underlyings traded on an RM, MTF <u>or OTF</u> that can be physically settled* *Excluding:* <u>REMIT wholesale energy products traded on an OTF that must be physically settled</u> **Other physically settled:** Other derivatives on eligible underlyings that can be physically settled if: ■ They are: – Traded on non-EU trading <u>venue</u> equivalent to RM, MTF <u>or OTF</u>; – Expressly stated to be traded on or subject to the rules of an RM, MTF, <u>OTF</u> or equivalent non-EU trading <u>venue</u>; or ~~– Expressly stated to be~~ equivalent to a contract traded on an RM, MTF, <u>OTF</u> or equivalent non-EU trading <u>venue</u>; ~~■ Cleared by a CCP or margined~~; and ■ Standardised so that price, lot, delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates *Excluding:* ■ Spot contracts (delivery within 2 trading days or market standard settlement period) ■ Contracts with operator/administrator of energy grid/balancing mechanism or pipeline for balancing purposes	■ Commodities ■ Climatic variables ■ Freight rates ~~■ Emission allowances~~† ■ Geological, environmental, physical variables ■ Inflation rates/economic statistics ■ Telecoms bandwidth ■ Commodity storage, transmission or transport capacity ■ Renewables allowances ■ Other transferable fungible assets or rights (other than services) ■ Any index or measure of prices or values of or transaction volumes in assets, rights, services or obligations † Derivatives on emission allowances fall within Section C(4) Annex I MiFID2
2. **Securitised derivatives**	
Securities giving rise to a cash settlement determined by reference to an eligible underlying *Excluding:* shares and bonds and other securitised debt	

- Competent authorities can give temporary exemption (until July 2020) from EMIR clearing/clearing threshold for physically settled oil/coal derivatives traded on an OTF (C6 energy contracts).

Sources: Arts. 4(1)(50) MiFID2 and 2(1)(30) MiFIR; Section C5, C6, C7 and C10 Annex I MiFID2; Art.4(1)(44)(c) MiFID2; ESMA technical advice (December 2014). <u>New</u> under MiFID2; ~~Changed~~ from MiFID1. ESMA consultation on guidelines indicates that derivatives include forwards (September 2014).

Ancillary activities exemption

Ancillary activities exemption

MiFID2, Article 2(1)(j)

- MiFID2 amends/deletes exemptions commodity dealers have historically relied upon
- New exemption for dealing on own account in commodity derivatives or emission allowances (and their derivatives) and providing investment services relating to those instruments to customers/suppliers of their main business on a group basis
- But exemption dependent on a number of criteria including: (i) the activity being **ancillary to the person's main business** on group basis *and* (ii) **annual notification** of intention to use exemption
- Only "investment firms" (as defined) need to rely on exemption

Activities are ancillary if less than both:*

Capital employed test

- 5% of group capital employed
- This represents a deviation from the approach suggested in the May 2014 DP in which a 50% threshold was proposed

and

Total trading test

- 0.5% of overall market activity in EU in at least one asset class:
  - Metals
  - Oil and oil products
  - Coal
  - Gas
  - Power
  - Agricultural products
  - Other commodities or C(10) underlyings
  - Emission allowances (and derivatives)

Relevant activities are groupwide EU activities excluding intragroup transactions under EMIR, hedging, mandated market making and authorised investment firm transactions

* ESMA proposal in December 2014 Consultation Document

Transparency obligations

Metals

- ESMA analysed data from 5 trading venues from 1 June 2013 – 31 May 2014.
- Sub-classes developed on the basis of underlying type (single name or index), specific underlying metal (e.g. aluminium, cobalt etc) and notional currency of the contract.
- Liquidity parameters and thresholds used: (1) average of 1 trade per day or more; and (2) average notional amount per day of EUR 100,000 or more.
- 40 sub-classes out of 49 identified were deemed liquid.

Energy

- ESMA analysed data from 7 trading venues from 1 June 2013 to 31 May 2014.
- Sub-classes developed on the basis of underlying type (single name or index), specific underlying source of energy (e.g. electricity, natural gas etc), notional currency of the contract and time to maturity.
- Liquidity parameters and thresholds used: (1) average of 1 trade per day or more; and (2) average notional amount per day of EUR 100,000 or more.
- 8 sub-classes out of 22 identified were deemed liquid.

Agricultural

- ESMA analysed data from 7 trading venues from 1 June 2013 to 31 May 2014.
- Sub-classes developed on the basis of specific underlying commodity (e.g. cocoa, coffee, corn etc).
- Liquidity parameters and thresholds used: (1) average of 10 trades per day or more; and (2) average notional amount per day of EUR 500,000 or more.
- 13 sub-classes out of 21 identified were deemed liquid.

Freights, emissions, weather and other exotic derivatives

- ESMA analysed data from trade repositories from 1 March 2014 to 31 May 2014.
- ESMA assessed liquidity at the level of underlying type (freights, emissions, weather, other exotics), but LIS/SSTI threshold may be set at a more granular level.
- ESMA found no liquid classes / sub-classes.

Position limits – an overview

National competent authorities will establish and apply position limits on the size of a <u>net position</u> which <u>a person</u> can hold at all times

- Calculating the net position ….

Subject of the Limits		Aggregation		Non-financial entity hedge exemption
positions held by that person in <u>commodity derivatives traded on trading venues</u> *and* <u>economically equivalent OTC contracts</u>	+	those held on its behalf at an aggregate group level	-	Positions objectively measurable as reducing risks directly related to the commercial activity of NFE

Position limits – key issues and questions

Who does the regime apply to?

- Article 57 refers to "persons"
- Article1(6) extends application of regime to "exempt persons"

Does the regime apply to persons who require neither authorisation nor exemption?

Setting the limits

- Methodology proposed by ESMA sets limits for spot and non-spot months (cash and physical) at 25% of deliverable supply (DS)
- NCAs can vary +/- 15%

How will DS be calculated where there is no physical underlying and for non-spot months?

Economically Equivalent OTC Contracts ("EEOTC")

- Do EEOTC need to be "commodity derivatives?
- Register of EEOTC?
- Does holding only EEOTC trigger limits?

Will EEOTC be interpreted broadly or restrictively?

Calculating the Net Position

- Limits apply to "net position"
- ESMA CP excludes third country venue contracts/ physical hedges/ REMIT contracts from calculation

Will the calculation reflect the real risk by including non-MiFID instrument offsets?

Group Aggregation

- Do ultimate holding companies who hold no positions have to aggregate?
- Aggregation proposal does not take into account independence and requires aggregation on "whole basis"

Do you have to aggregate "up the chain"?

Position reporting

Reportable Products: commodity derivatives, emission allowances and related derivatives and (for firm/participant reporting) EEOTC

Venue Reporting *

Aggregated Daily Breakdown

- **Content:** A complete breakdown of the positions held by all persons on that venue
- **Report to:** relevant NCA

Aggregated Weekly Breakdown

- **Content:** Aggregated weekly breakdown of positions held by different categories of persons traded on that trading venue specifying number of long and short positions, changes since previous report, percentage of open interest represented by each category and number in each category
- **Report to:** NCA and ESMA

Firm/Participant Reporting

Daily Venue Report

- **Content:** Members / participants / clients of an EU trading venue must report details of their own and client (down to end-client) positions
- **Report to:** relevant venue

Daily Off-Venue Report

- **Content:** Investment firms trading outside an EU trading venue must report a complete breakdown of their own and client (down to own-client) positions in in-scope products traded on EU trading venues and economically equivalent OTC contracts
- **Report to:** relevant NCA of venue or central NCA, in accordance with the transaction reporting regimes under MiFIR and, if applicable, REMIT

Key Implementation Issues

- Duplicative reporting
- End-client reporting – data protection, confidentiality and commercial concerns

* based on information received from member/participant in Daily Venue Report

Position management powers

Position management

Operators of trading venues trading commodity derivatives must apply position management controls, including powers to:

- Monitor open interest
- Access information about size and purpose of a position
- Require a person to terminate or reduce a position
- Require a person to provide liquidity

Other powers for competent authorities

- Temporary additional position limits in exceptional cases (valid for up to 6 months)
- Additional supervisory powers (including power to require a person to provide information on commodity derivatives, to reduce their position or to limit the ability of a person or class of persons to enter into a commodity derivatives

ESMA powers

- Market monitoring and power to ban products / activities
- Co-ordination of national measures
- Additional position management powers

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