Bloomberg BNA

WORLD SECURITIES LAW REPORT >>>

News and analysis of securities law developments around the world.
For the latest updates, visit www.bna.com

International Information for International Business

VOLUME 21, NUMBER 11 >>> NOVEMBER 2015

ESMA's Draft Standards on the Ancillary Business Exemption Available for Commodity Trading Activity under the EU's MiFID 2

By Luca Salerno and Rosali Pretorius, of Dentons UKMEA LLP, London.

The EU's Markets in Financial Instruments Directive reform package, comprising a new Markets in Financial Instruments Directive and a new Markets in Financial Instruments Regulation (MiFIR) — collectively known as MiFID 2 — was published in the EU Official Journal in June 2014. It will introduce significant changes for investment firms and other financial markets participants when it is implemented by EU member states (*see Special Report by Emma Radmore and Juan Jose Manchado, of Dentons UKMEA LLP, London, at WSLR, October 2014, page 3*).

The MiFID 2 package will take effect (with a few exceptions) from January 3, 2017. We still await key technical measures.

Following the European Securities and Markets Authority's (ESMA's) discussion, consultation and advice papers on MiFID 2 published last year, ESMA published its second set of final drafts of key Implementing Technical Standards (ITS) and Regulatory Technical Standards (RTS) on September 28, 2015, for the European Commission to approve (*see analysis by Emma Radmore and Rosali Pretorius, of Dentons UKMEA LLP, London, at WSLR, October 2015, page 3*).

The Commission was given three months to consider the standards and either accept them or propose changes. In practice, the changes ESMA has made from its drafts and the length of the report make it hard to believe the Commission will be able fully to assess the standards within this period. As of November 3, 2015, it had not published its views on the five standards ESMA submitted on June 29, 2015. In principle, though, it must respond on all the September 2015 standards by December 28, 2015, just over one year before MiFID 2 takes effect.

This article examines the contents of RTS 20 (formerly 28) on the criteria for establishing when the commodity trading activity of an entity benefits from the only exemption available to commodity traders under Article 2(1)(j) MiFID.

How Does MiFID 2 Affect Commodity Derivatives Dealers?

Provided the conditions listed in Article 2(1)(j) of MiFID 2 are met, those who deal on own account in commodity derivatives, or who provide investment services (*e.g.*, dealing as riskless principal) to customers or suppliers of their main business, are outside the scope of MiFID 2.

The conditions are that the trading activity of the entity in question is ancillary to the main business of the wider group of companies of which the entity is a part, that the entity does not engage in high frequency algorithmic trading, and that the entity notifies the relevant authority each year that it is using the exemption.

Article 2(4)(a) MiFID 2 specifies that, in order for the activity to be considered ancillary, it must be a "minority activity" at group level. One can think of this as an internal test. It requires comparison of the trading activity against the activities of the group of which the trading entity is a part.

Article 2(4)(b) MiFID 2 provides a further element to be taken into account: "the size of their trading activity compared to the overall market trading activity in that asset class". This is an external test. This test compares the trading activity against the trading activity that exists in the wider marketplace.

MiFID 2 requires ESMA to develop RTS to specify when an activity should be considered ancillary to the main business at a group level, taking account of the elements in Article 2.4(a) and (b). As a result, ESMA first consulted on, and has now included in its September 2015 final report, what is now RTS 20. ESMA received significant responses to its consultation, and made some changes and additions to its proposals as a result. In its final report accompanying the final form RTS, it included useful explanations and diagrams to show how it envisages the tests will work.

The Structure of RTS 20

RTS 20 is made up of 18 recitals and six articles.

Among the key points made in the recitals are:

- A "group" comprises the parent undertaking and all its subsidiaries, regardless of whether they are within or outside the EU;
- The tests are intended to prove that a rational risk-averse entity such as a producer, processor or consumer of commodities would seek to hedge the volume of commercial business with an equivalent volume of commodity derivatives, so the turnover volume would be an appropriate proxy for the size of the group. Whereas, if the main business of the group did not relate to commodities, it would not use commodity derivatives as a risk-reducing tool, and therefore its trading would be assumed to be speculative;
- Notwithstanding the previous point, the test should have a back-stop mechanism that recognises that trading needs to exceed a certain percentage based on set thresholds in order for the entity to fail the ancillary business test; and
- Generally, to take account of seasonal and other differences, entities should make calculations based on both tests annually, but on a rolling three-year average.

Article 1 introduces the external and internal tests that are dealt with in Article 2 and Article 3, respectively (so in reverse order by reference to (a) and (b) in Article 2(4)).

In particular, Article 1 makes it clear that, in order to benefit from the exemption of Article 2.1(j) MiFID, a firm's activities must satisfy both the external and internal tests.

Also, it specifies that the external test of Article 2 applies to any individual trading entity within the group, whereas the internal test applies to the group as a whole.

Both tests are informed (in different ways, as we explain below) by the following ratios by reference to commodity asset classes:

- 4 percent in relation to derivatives on metals;
- 3 percent in relation to derivatives on oil and oil products;
- 10 percent in relation to derivatives on coal;
- 3 percent in relation to derivatives on gas;
- 6 percent in relation to derivatives on power;
- 4 percent in relation to derivatives on agricultural products;
- 15 percent in relation to derivatives on other commodities, including freight and commodities referred to in Section C 10 of Annex I to MiFID 2; and
- 20 percent in relation to emission allowances or derivatives thereof.

The External Test

Article 2 provides that the "speculative trading activity" (this term captures the concept but is not actually used in Article 2) of the entity in any given asset class compared with overall market trading activity in that asset class must not exceed the prescribed ratio.

Speculative trading activity (the numerator of the fraction) is what is described in Article 2.2, namely, activity in relation to derivatives contracts that are not "excluded contracts" (as referred to in Article 2(4) MiFID 2), namely:

- intra-group serving group liquidity and risk management (hedging for group companies);
- transactions objectively measurable as reducing risk relating to commercial and treasury activity (*i.e.*, hedging as described in more detail in Article 5 of the RTS also by reference to the concept of "hedging contract" pursuant to International Financial Reporting Standards; and
- compulsory trades aimed at providing market liquidity.

Speculative trading excludes transactions executed in an entity of the group authorised under MiFID.

Overall market trading activity (the denominator of the fraction) is the combination of the market activity that goes on in the derivatives market as a whole in relation to the class of underlying (Article 2(3)).

For over-the-counter (OTC) derivatives, this means all

   ISSN 1357-0889

derivatives contracts entered in relation to that commodity where at least one of the parties to it is an EU entity.

For exchange-traded transactions, one must look at all contracts (*e.g.*, futures positions) traded on a EU trading venue, irrespective of whether the holder of the position is based in the EU.

Both measures of speculative trading and overall trading activities take into account the gross notional volume denominated in euros. The calculations must be made every year (from July 1 to June 30) and are based on the simple average of trading activities carried out the preceding three years (Article 4). The calculation will be based on the shorter July 1, 2015, to June 30, 2016, period for the first year MiFID 2 comes into force (*i.e.*, 2017). For 2018, one will have to look at the two-year period from July 1, 2015, to June 30, 2017.

The Internal Test

Article 3 allows firms to presume that their derivatives trading is a minority activity at group level if the aggregate of speculative trading activity (as described above) undertaken by all entities in the group across all commodity asset classes does not account for more than 10 percent of all derivatives contracts (*i.e.*, including both speculative and non-speculative contracts) entered into by group companies. As is the case with Article 2, the measure of both the numerator and the denominator is gross notional volume of annual trading activity.

However, if the ratio between group-wide speculative and non-speculative trading is more than 10 percent but less than 50 percent, then it cannot be considered minority activity unless the ratio between: 1) the group-wide gross notional amount of derivatives in respect of each commodity asset class and 2) the overall market activity in that asset class is less than 50 percent of the ratio specified in Article 2 for that asset class.

If the ratio between group-wide speculative and non-speculative trading is equal to or more than 50 percent, then it cannot be considered minority activity unless the ratio between: 1) the group-wide gross notional amount of derivatives in respect of each commodity asset class and 2) the overall market activity in that asset class is less than 20 percent of the ratio specified in Article 2 for that asset class.

By way of example, if oil group "Alfa" is made up of two entities, "Alfa 1" and "Alfa 2", and each such entity's speculative trades referencing ICE Brent crude oil account for less than 3 percent of the open interest in ICE Brent crude oil, then both benefit, *prima facie*, from the exemption.

However, if the combined speculative trading activity of the two entities is equal to 25 percent of Alfa group's overall trading activity in derivatives (*i.e.*, the overall trading activity is relatively heavily skewed toward speculative trading), then Alfa 1's and Alfa 2's trading activity will be measured against the more stringent threshold of 50 percent of 3 percent, namely 1.5 percent.

What Does This Mean?

It can be argued that the external test is incongruous insofar as it does not compare like for like by looking at the ratio between speculative trading of the individual entity against overall market activity, which encompasses both speculative and non-speculative trading.

Take a derivatives market where 3 percent is the prescribed ratio. Say in that market the gross notional amount of the derivatives is twice the amount of underlying physical commodity, and half of those derivatives are hedges and half are speculative.

Under the external test, an entity with 4 percent of speculative trades would not pass the ancillary business test. And that would be the case even if the same entity controlled as much as 50 percent of the physical stock, which it hedged like for like. Those hedges would account for 25 percent of all derivatives. The speculative activity would constitute 16 percent of its overall trading. Surely that would be "ancillary" — as usually understood?

It seems that ESMA is seeking to expand its remit and regulate any trading activity which it considers significant, rather than ancillary.

As to the internal test, it makes no reference whatsoever to the criterion of capital employed for speculative trading activities versus capital for non-speculative activities. This departs from the original intention of Article 2(4) MiFID.

A capital-based test had been adopted by the first draft RTS but has since been abandoned due to its inherent complexities that attracted criticism by market participants.

Also, where the 10 percent ratio is exceeded, the internal test does ultimately rely on the spurious and arguably arbitrary ratios of the external test, except that — to make things worse — the actual percentages are lower.

In the light of the above, it could be argued that the legislator sacrificed objectivity in the pursuit of certainty and ended up devising tests that may have unintended and unnecessary negative consequences when applied.

Another controversial element of the RTS is the calculation of the overall market trading activity in any given asset class. Many doubt that a set of univocal data on the size of individual markets can be made available to all relevant stakeholders. Certainly no official body has been tasked with gathering and publishing these data.

Also, considering the slow uptake in the commodities markets of the transaction reporting requirements under the European Market Infrastructure Regulation (EMIR) — the EU regulation governing OTC derivatives, central counterparties and trade repositories — and the EU Regulation on Energy Market Integrity and Transparency (REMIT), it cannot realistically be expected that regulators will have a full picture of the derivatives markets and, particularly, of the OTC segment.

Conclusion

ESMA has clarified its views on which exemptions can be combined for firms that want to stay outside the scope of MiFID 2. Commodity firms that currently use one or more of the MiFID 1 exemptions will need carefully to assess whether the relevant part of the exemption(s) has been carried over to MiFID 2 and, where appropriate, reflected in the RTS, and whether, if they previously combined exemptions, they can still do so.

If a firm previously exempt from MiFID will need to be authorised under MiFID 2, this is no easy process. Firms will have to assess not only the difficulties of the onerous application process, but also the initial and ongoing capital, organisational and compliance requirements, and the knock-on effects of being an "investment firm" (for example, they will be considered financial rather than non-financial counterparties for the purposes of EMIR, and the trading obligation will apply in full without being subject to a threshold).

Assuming the Commission adopts the RTS, there is no wriggle room. Firms that may be affected should be making their calculations and plans now.

The text of ESMA's September 28, 2015, final draft technical standards under MiFID 2 is available at https://www.esma.europa.eu/system/files/2015-esma-1464_-_final_report_-_draft_rts_and_its_on_mifid_ii_and_mifir.pdf.

Luca Salerno (Counsel) and Rosali Pretorius (Partner) are members of Dentons UKMEA LLP's Financial Services and Funds Practice in London. They may be contacted at luca.salerno@dentons.com and rosali.pretorius@dentons.com.

   ISSN 1357-0889