



Ensuring effective and efficient regulation of European commodity derivative markets

4 September 2015

Dear Commissioner,

We are writing on behalf of seven commodity industry associations and commodity firms and pursuant to our meeting with you on 20 July. We thank you for taking the time to meet with us and very much appreciate your efforts to ensure that Union financial services legislation fosters efficient and transparent markets in turn aiding the European Commission's jobs and growth agenda.

We recognise that the Commission has a legislative mandate to discharge with regard to implementing MiFID II and MiFIR and also to defining an appropriate prudential regime for commodity trading firms under CRR/CRD. In relation to MiFID II, there is a need to ensure the ancillary exemption framework incorporates an appropriate assessment in relation to the overall group business, consistent with the intent of the legislators. The present proposals from ESMA do not achieve this and also have a number of other serious deficiencies (including the approach to defining legitimate hedging activity and the starting year for assessment against the thresholds). Together, these problems will result in a large number of firms being brought into the scope of MiFID even though their activity in commodity derivative markets is, by any reasonable assessment, ancillary to their wider group business. For those firms that are in scope of MiFID the development of an appropriate prudential regime under CRR/CRD will be a crucial issue. Any requirements must reflect the specifics of commodity markets and the business activity of those firms falling under prudential regulation. Restrictive and badly calibrated requirements will only serve to divert capital from productive employment with a resulting negative impact on investment and growth. The first step in relation to CRR/CRD is to extend the current exemption so that time can be spent developing a framework that is fit for purpose. While an appropriate regime of prudential supervision may mitigate part of the impact on firms, it is by no means sufficient to avoid all of the costs and negative impacts that would stem from requiring commodity market participants to become MIFID-licensed entities. The negative impacts on investment and growth therefore require both a workable ancillary activity exemption and proportionate capital rules.

Both MiFID II and CRR/CRD have the potential to present fundamental challenges to the business models of commodity trading firms and the efficient and effective operation of both the derivatives and underlying physical commodity markets. Commodity markets and their participants are a significant driver of economic growth and investment in the EU. No one wants to see an outcome where this role is undermined through the application of badly designed regulation. All stakeholders should share the same objective of ensuring the regulatory framework underpins integrity and efficiency of markets while allowing firms to continue to grow and invest. The rest of this letter sets out our list of priority measures, as requested at the meeting, which we jointly feel can deliver this balance.

We hope you will bear these points in mind as you decide on the regulatory measures you bring forward for agreement with the Council and European Parliament. If we can provide additional information or clarity on any of the points we have raised please let us know.

1. A workable ancillary activity exemption

Firstly, we consider a workable ancillary activity exemption under Article 2(1)(i) MiFID II vital for non-bank commodity market participants. We welcome some aspects of the revised approach on the Article 2(1)(j) MiFID II exemption that the European Securities and Markets Authority (ESMA) is likely to propose. However, we believe the following changes are required to this revised proposal:

- (1) We share the concerns of European legislators and oppose the revised “trading activity” test suggested by ESMA. Although the market share test has been eased a little, the removal of any test measuring the proportion of capital employed in different parts of an overall business means the scale of a company's non-trading asset base becomes irrelevant. Companies with an underlying physical business and a corresponding asset base would be treated the same way as companies which have not invested in and do not operate assets. This prevents a true assessment of the relationship between the trading activity and the rest of a group business involving the production, processing and supply of energy resources. Such an assessment must be axiomatic to any proper implementation of the "ancillary" test determined by the EU legislature. We do not believe that hedging activity in financial instruments can or should be used as a proxy for a person's main business for the purposes of the exemption. Hedging activity is not a viable proxy as it ignores the significant investments of commodity market participants in fixed assets and resource-intensive activities entirely unrelated to derivative markets.
- (2) We recognise that the market share thresholds suggested by ESMA for each of the eight commodity classes have been raised. However, we consider that the thresholds remain too low given the stricter approach now taken to non-hedging activity and the tightening of the description of what is considered to be hedging (see sub-paragraph (3) below.) There will be wider impacts on industry and the economy of casting the MiFID net too wide. Given the lack of robust data available about market size and market shares, we call for additional caution. ESMA nonetheless retains the right to propose changes in the RTS at a later date in light of better data and market developments. We advocate a minimum threshold of 10%, increased accordingly for the “C10” and “emissions/derivatives thereof” asset classes reflecting the characteristics of those markets and the absence of an exemption for positions in emission allowances and related derivatives.
- (3) We are concerned by the inclusion in the draft RTS of the ESMA guidance on portfolio hedging contained in the ESMA Q&A on EMIR. If enacted, this will seriously compromise the effective operation of the ancillary activity exemption and run counter to the intentions of the co-legislators under both EMIR and MiFID II. We therefore ask the Commission to support amendments to (a) include express reference to the hedging effects of derivative contracts in combination with other contracts and through closely correlated instruments, (b) remove the prohibition on classifying portfolio hedges as objectively measurable as reducing risks directly relating to commercial activity and treasury financing activity, and (c) remove the exclusion from the hedging exemption for necessary components of a portfolio that may not be demonstrated as objectively measurable as reducing risks.
- (4) Firms must be permitted an opportunity to take strategic decisions about the future of their business in response to the new regulatory framework. We believe that the Article 2(1)(j) MiFID II exemption should be phased in over a three year period commencing 3 January 2017. This would allow eligible persons seeking to avail themselves of the exemption sufficient time to (a) assess their compliance with the conditions of the exemption, and (b) seek authorisation as an investment firm where they are unable to make use of the exemption. We consider it inappropriate to apply Article 2(1)(j) ahead of other MiFID II provisions and we note no impediment in the legislation to such a proportionate phase-in period. At the very least, if the Commission decides to start the clock ticking before 2017 then activity executed before that date must be assessed with a lower weighting against the thresholds.
- (5) The Commission must also ensure ESMA publishes robust data (including the definition of the ‘market’) so that firms can make their own assessment against the clearing thresholds. The market should have the opportunity to assess whether ESMA's definitions are fit for purpose.

- (6) We support the 'categories of person' approach proposed by ESMA. However, we suggest that categories of <25%, 25-50% and >50% would be more appropriate than those proposed by ESMA. Thresholds should be reduced accordingly by multiples of 0.75 and 0.5 respectively.
- (7) We suggest that the risk-reducing effect of Regulated Markets (RMs) should also be recognized similar to exchange traded derivatives (ETDs) under EMIR. Contracts traded on RMs are always centrally cleared and thus have a different risk profile than non-cleared contracts traded outside regulated platforms. RM-traded contracts should therefore only be partially taken into account for the calculation of ancillary activity thresholds with a maximum ratio of 15 % (corresponding with the level of initial margin placed with the CCP).

2. A measured and practical position limits regime for commodity derivatives

Secondly, we accept that the MiFID II legislation mandates an expansive regime of position limits for commodity derivatives. We also recognise that the MiFID II position limits regime has been and remains subject to emotive lobbying by some stakeholders. Position limits are no substitute for market supervision nor do they fix prices, preclude market abuse or dampen volatility as some stakeholders contend. In fact, applied carelessly position limits may reduce liquidity and increase volatility in derivative contracts.

- (1) We urge the Commission to support ESMA's proposal to permit national competent authorities to set lower or higher position limits against the baseline limit. We do not believe that a position limit of 25% deliverable supply or open interest is appropriate for all prompt month contracts. Higher or lower limits will be appropriate for different contracts. Different limits will be required to foster liquidity in non-spot month contracts.
- (2) We generally support ESMA's proposal for an *ex-ante* position limit exemption procedure. However, and as with the Ancillary Activity exemption, this procedure needs revised prescription on hedging generally and on portfolio hedging in particular. We ask the Commission to direct ESMA to review and amend the guidance and to include corresponding amendments in the draft RTS as summarised above.
- (3) We believe the annual hedging exemption should be complemented with a mechanism for non-financial entities to seek position limit exemptions on an *ex-post* basis – for example to react to unexpected events such as outages at physical infrastructure. This mechanism should require prompt assessments by national competent authorities to minimise disruption and prevent disorderly trading.
- (4) We encourage the Commission to support changes to the aggregation provisions for the further implementation of Article 57(12) MiFID II. We have grave reservations as regards ESMA's "whole position basis" approach for aggregating positions. We believe that aggregation should be restricted to a person's fully consolidated subsidiaries only. We also believe that parent undertakings should be able to exclude from aggregation the positions of subsidiaries over which they have no control and for which they may be unable to use the proposed hedging exemption. We consider the suggested amendments to be consistent with the provisions of Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings (Accounting Directive) as well as the application of comparable provisions of EMIR.

3. A cautious approach to pre-trade transparency and non-discriminatory access

Thirdly, and while we are committed supporters of transparent markets, we are greatly concerned by what we fear to be the negative, unintended consequences of MiFIR provisions mandating pre-trade transparency for non-equities, and non-discriminatory access to trading and clearing. We consider that the following amendments to MiFIR technical standards would ensure efficient trading venues and preserve liquidity in key commodity derivative contracts without compromising the objectives of the legislation.

- (1) On pre-trade transparency for non-equities, we ask the Commission to support an exception to application of the large-in-scale (LiS) waiver that would permit trading venues to derogate from the publication requirement under certain conditions and in the interests of maintaining orderly trading. We further believe that contingent transactions (e.g. “exchange-for-physical”, “against actuals”) behave as distinct financial instruments and should be ascribed separate and appropriately-calibrated LiS thresholds. Such transactions are common in European commodity derivative markets and are essential for commodity market participants seeking to hedge complex commercial risk. We are concerned that incorrectly calibrated LiS thresholds for these transactions may expose commodity market participants to undue market risk.
- (2) We encourage the Commission to implement Article 35 MiFIR with caution. We believe that the liquidity fragmentation that will inevitably follow mandatory access to clearing will be most acute in key commodity derivative contracts used by commercial market participants. We consider that central counterparties (CCPs) should be able to deny access requests where to grant a request may be in breach of its legal obligations in other jurisdictions or may otherwise expose the CCP to legal action.
- (3) We caution the Commission as to the hazards of mandating the netting of derivative contracts. “Economically equivalent” derivative contracts are not the same, and variations in national insolvency regimes mean that in many cases such contracts cannot and should not be netted. Mindful of the aims of Article 35 MiFIR, we ask that the Commission support amendments to the draft RTS to (a) require the prior consent of all trading venues for the netting of economically equivalent contracts, and (b) provide appropriate discretion for CCPs to determine where netting is permissible.

4. Appropriate prudential supervision for commodity dealers

Finally, we urge a very careful assessment of any application of prudential regulation to commodity market participants particularly aspects that would impose quantitative requirements on firms. There is no evidence that commodity trading firms are systemic and require restrictive capital requirements. We believe that such requirements have the potential to drive market participants from, and fundamentally undermine, European commodity derivative markets. The vast majority of EU-established participants in physical commodity and commodity markets are commercial producers, merchandisers and consumers and not credit institutions. We do not believe that prudential requirements such as minimum own funds requirements, large exposures limits and Liquidity Requirements (including the Liquidity Coverage Ratio (LCR)) are appropriate or warranted for commercial market participants, including those unable to avail of MiFID II exemptions.

- (1) We urge the Commission to adopt amendments to Articles 493 and 498 CRR extending the so-called “commodity dealer” exemptions to 31 December 2020. Such an extension would provide sufficient time for the Commission to properly assess and report to the Council and European Parliament as to appropriate prudential supervision for commodity dealers. However, the other CRD IV / CRR requirements would continue to apply to commodity dealers and this would require considerable financial resources and IT, operational and human resource changes.
- (2) With a view to ensuring a level playing field between licensed “commodity dealers”, it should also be clearly stipulated in such exemption regime that commodity dealers licensed prior to 31 December 2006 are able to benefit from these exemptions (without opt out right for the Member States). No discriminatory regime should apply between commodity dealers licensed prior or after 31 December 2006. Equally, any Commission decision on a potential future application of the Liquidity Coverage Ratio to commodity dealers should be aligned to 31 December 2020.
- (3) We ask that, following adoption of these amendments, the Commission carefully considers whether mandatory own funds requirements and large exposure limits are appropriate for commodity dealers that are affiliates or subsidiaries of commodity producers, merchandisers and consumers. Previous such reviews have provided no justification for mandating own funds requirements for commodity dealers. We consider the large exposures regime to be wholly inappropriate for persons managing risk on behalf of a parent company or other commercial affiliates. We believe it is vital that the Commission consider commodity dealers separately and

not simply apply variations of own funds requirements developed for other types of investment firm.

- (4) We note the requirements of Article 508(2) CRR. We do not consider the Part 6 CRR requirements on liquidity to be in any way applicable to commodity dealers. We ask the Commission to propose Part 6 requirements not being applied to commodity dealers in its report to the Council of Ministers and European Parliament.
- (5) Should the Commission propose to mandate own funds requirements for commodity dealers, we consider it essential that it both (a) conducts and makes public a full quantitative impact study (QIS) prior to proposing amendments to CRR, and (b) sets out in legislation a transitional regime comparable to that granted previously to credit institutions and investment firms.

We believe that the above actions on the part of the Commission would contribute to the efficient and effective regulation of commodity derivative markets in Europe without eliminating liquidity and substantially raising the cost of risk management and thus the price of energy, food, manufacturing and transport. We consider these actions proportionate and consistent with the objectives and purposes of the relevant Union legislation.

We hope that you will consider the above actions and we remain at your disposal to provide any additional information on these actions and why we consider these actions to be necessary.

Yours sincerely,

David Peniket and Peter Styles

For and on behalf of all the above-mentioned associations and groups