MIFID II - COMMODITY DERIVATIVES

KEY TAKEAWAYS FROM FINAL REPORT

Associates in Capital Markets

The ESMA has released its final report on draft regulatory and implementing technical standards for MiFID II and MiFIR in September 2015. Markets in Financial Instruments Directive (MiFID II) has been a long drawn process in European capital markets starting from 2011 as a critical response to the financial crisis. It was set up with the key objectives of fair competition and consumer protection in investment services. In its latest iteration as MiFID II, various changes have been proposed by ESMA to be adopted by Jan 2017.

MiFID II and Commodity Derivatives

The provisions in MiFID II and MiFIR related to Commodity Derivatives deal with the objective of enhancing the oversight and transparency of the commodity derivatives markets. The underlying intention was also to address the excessive volatility in the commodity prices.

Exemptions – Establishing when an activity is considered ancillary

According to the latest report, the exemptions provided in earlier iteration of MiFID I [Article 2(1)(i) and 2(1)(k)] are subject to a "more narrow interpretation" primarily aimed at addressing the competitive distortions that may arise.

Eligibility

In line with this, the new exemption now is applicable to (i) firms that deal on own account or (ii) firms dealing on behalf of the customers of their main business, provided they satisfy certain conditions.

The above exemption is narrowed to ensure that the commercial users and the producers of commodities be protected, since they do not pose any systemic risk like traditional financial institutions nor do they influence investors (who may be put at risk).

Determination of Activity as Ancillary

Whether an activity is considered as ancillary is defined by ESMA in technical standards for the uniform application of the exemptions across EU.

The two main criteria to be used for classification would be:

- Main Business Threshold: The need for ancillary activities to be a minority of the firm's activities at the group level by measuring the size of "speculative trading" over total group trading
    - Varying limits Based on ratio of: Trading activity size excluding privileged transactions and transaction executed by authorised entities of the group undertaken in all asset classes / Overall Trading activity including privileged transactions and transaction executed by authorised entities of the group undertaken in all asset classes
- Trading Activity Threshold: The size of the firms' trading activity compared to the overall market trading activity in that particular asset class.
    - Varying thresholds proposed for different classes.

The practical implication of the changes in exemptions mentioned above is that all those firms which were operating under exemptions would now have to re-evaluate their positions in the light of these changes. For those firms which now move out of the purview of the exemptions, there is the challenge of complying with the new rules applicable to the organisation, conduct, and capital.

Exemptions	Conditions
Available to: (i) Firms dealing on own account (excluding persons who deal on own account when executing client orders) (ii) Firms dealing on behalf of customers of their main business IF	The activity is "ancillary" to main business on a group-wide* basis *Parent undertaking including all its subsidiaries
	Main business is not the provision of Investment services under MiFID II or banking activities under Directive 2013/36/EU
Further Requirements	Notify the competent authority annually on the use of exemption
	Provide basis of the claim for exemption on demand

Figure 1: Exemption Eligibility Criteria


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Position Limits and Reporting

MiFID II paves the way for the new regime of position limits and position reporting for commodity derivatives. The key objective of this is to prevent market abuse and address systemic risk.

Calculation Methodology

MiFID II requires that the position limits should be set by competent authority of each member state for commodity derivatives traded on regulated markets (RMs), multilateral trading facilities (MTFs) and organised trading facilities (OTFs) and other economically equivalent OTC derivatives.

Accordingly, it is proposed to have separate methodologies for setting position limits for spot month and all other months. These limits will be applicable to physically delivered commodity derivatives, cash-settled commodity derivatives, commodity derivatives with no deliverables and securitised commodity derivatives

	Spot months			Other months		
	Baseline measure	**Baseline %**	**CA flexibility to deviate from baseline based on factors**	**Baseline measure**	**Baseline %**	**CA flexibility to deviate from baseline based on factors**
Physically delivered commodity derivatives	Deliverable supply	25%	+10%- 20%	Open interest	25% of total open interest unless open interest is less than 10,000 lots in which case, baseline is 2,500 lots	+10%- 20%
Cash settled commodity derivatives	Deliverable supply	25%	+10%- 20%	Open interest	25% of total open interest unless open interest is less than 10,000 lots in which case, baseline is 2,500 lots	+10%- 20%
Commodity derivatives with no deliverable	Open interest	25%	+10%- 20%	Open interest	25% of total open interest unless open interest is less	+10%- 20%

Figure 2: Calculation Methodology


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Application of Position Limits

The limits will be applicable on the net (sum of long and short) position in a commodity derivative that can be held by a person or held by the group entity on the person's behalf. The position defined must take into account the aggregated position of all its subsidiaries.

Where certain commodity derivatives are traded in significant volumes across multiple jurisdictions, there should be a single position limit which applies to all the relevant countries. In doing so, the limit is to be set based on the trading venue with the largest average daily volume.

Trading venues are also responsible for application of management controls including monitoring of open positions, information access related to the size and purpose of position, ability to require termination or reduction of positions and to provide liquidity to market to mitigate dominant position.

While the imposition of position limits and management controls is the primary responsibility of the relevant competent authority of the member state, ESMA will be responsible for coordinating on the whole by enabling effective information exchange between member states.

Category	Volume
Commodity Derivatives	Avg. Open Interest > 10,000 lots (spot + other months) on trading venue over 3 consecutive months
Securitised Commodity Derivatives	(No. of units traded*Price) > Avg. Daily Amount of 1,000,000 EUR

Figure 3: Application of Position Limits

Concluding Remarks

While it is clear that the new revision to MiFID has a comprehensive influence across the board, it is also a right step in the direction of enhanced investor protection and market integrity. With the application date set in the first quarter of 2017, the implementation effects of the new directive and regulation will have a vast impact on the firms.

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Associates in Capital Markets

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