Future EU 27 Commodity Markets Exemption under the MiFID II Review
(12.05.2020)

1. Content

The ongoing review of MIFID II (Directive 2014/65/EU on markets in financial instruments) should deal with the current Ancillary Activity Exemption of Non-Financial Firms from MiFID II licensing requirements. In this context, the purpose of this paper is to describe: the current MiFID II exemption for commodity markets (point. 3 below), the risks triggered by a (no-deal) Brexit for the efficiency of this exemption for EU27 commodity markets (point 4 below) and the proposal for a future EU 27 Commodity Markets Exemption in a (no-deal) Brexit scenario (point 5 and Annex 1 below). The main outcome of this analysis is that it is necessary and justified to introduce a simple and robust Commodity Markets Exemption from MiFID II licensing requirements for Non-Financial Firms in order to mitigate the adverse impact of a (no-deal) Brexit on the real economy.

2. Summary

We believe that open, robust, liquid, competitive and transparent commodity markets are key to ensuring a secure, sustainable and competitive commodity supply, in particular gas and power, to the real economy and end customers in Europe. Non-Financial Firms across the entire real economy sector are using commodity and commodity derivatives markets to procure commodities for their industrial production and to hedge their commodity price risks. Commodity trading firms provide sufficient liquidity to enable these real economy activities.

In this context it is of utmost importance for Non-Financial Firms using commodity, commodity derivatives, EUAs and EUA derivatives markets (hereinafter: “Non-Financial Firms”) to benefit from an exemption from the licensing requirement under MiFID II, thereby avoiding burdensome and costly financial market regulations, in particular prudential regulation. This is currently ensured through the so-called Ancillary Activity Exemption (Art. 2 (1) j and Art. 2 (4) of MiFID II; hereinafter: “Ancillary Activity Exemption”) which has a Market Size Test at its core. This will need to be revised, especially if, having left the EU, the UK does not agree a relationship for financial services addressing this exemption (hereinafter a *“(no-deal) Brexit*”). ESMA stated in its MiFID II review report on position limits and position management of 1st April 2020 (hereinafter: “ESMA MiFID review report”) that it “*shares the views expressed by stakeholders on the impact of Brexit on the MiFID II framework for commodity derivatives and the ancillary activity exemption*” and, therefore, “*strongly encourages the EC to take the opportunity of the earliest possible amendment to MiFID II to review the ancillary activity exemption and the criteria thereof.*”[1]

There are good reasons in favour of keeping the current scope of the Ancillary Activity Exemption in a post Brexit world:

- Currently, EU Non-Financial Firms active on commodity and commodity derivatives markets are exempted under the Ancillary Activity Exemption from the MiFID II licensing requirement. To our knowledge this outcome has not caused any concern in relation to the functioning and stability of the wider financial markets, nor with regard to market integrity and transparency. On the contrary, this exemption has delivered its intended aims of fostering the liquidity of EU commodity markets. Real economy companies can therefore adequately manage their commercial risks (by hedging) and avoid an increase in energy prices for consumers triggered by burdensome and costly compliance requirements.
- The EU has an interest in well-functioning, effective and competitive wholesale and derivative trading markets post Brexit and in keeping and developing the liquidity in these markets further, for example by creating new liquidity pools in the EU27. This is in particular important when the size of the EU commodity and commodity derivatives markets and liquidity in certain global asset classes, such as emission allowances, metal, oil and coal, will be very low in the event of a (no-deal) Brexit, as these commodities are mainly traded on UK exchanges. A MiFID II licensing obligation for EU27 Non-Financial Firms would harm this aim as it would reduce the liquidity of all commodity derivatives markets even further and put EU27 Non-Financial Firms at a competitive disadvantage vis-à-vis those from 3rd countries.

[1] ESMA’s MiFID II review report on position limits and position management (1 April 2020 – “ESMA MiFID Review Report”), p. 39, nos. 138 and 139.

- A comparative regulatory study with regard to 3rd country jurisdictions (USA, Singapore, Switzerland; see Annex 2) shows that other legal systems have more simple exemptions than in the EU, which – albeit in different ways – lead to an exemption for Non-Financial Firms active in trading commodity and commodity derivatives in those 3rd country jurisdictions, in particular when trading on their own account. We are therefore of the opinion that an EU exemption for Non-Financial Firms without quantitative tests (hereinafter: a "*Commodity Markets Exemption*") would help to guarantee a level playing field for European companies and maintain the competitiveness of the EU vis-à-vis 3rd countries.

Therefore, the political interest should be to put in place such regulation of commodity markets which will keep and develop liquidity and market places in the EU27.

To achieve these aims it is preferable to introduce a *qualitative* Commodity Markets Exemption for Non-Financial Firms which assesses the nature of their trading activities (see point 5 below). This Commodity Markets Exemption would continue to exempt the same population of Non-Financial Firms and the same activities as under the current Ancillary Activity Exemption, i.e., Non-Financial Firms trading with commodities and commodity derivatives, emission allowances and derivatives thereof on their account and / or providing financial services to the customers or suppliers of their main business. Such an exemption for Non-Financial Firms would provide a simple, efficient and robust long-term solution, ensure that all Non-Financial Firms active in the commodity markets and commodity asset classes are treated in a similar manner and create a level playing field vis-à-vis 3rd countries. This approach can be achieved through a relatively simple change of the Level 1 text of MiFID II (see wording proposal in Annex 1).

We believe that the alternative approach to amend the current *quantitative* methodology of the Ancillary Activity Exemption (for example through an increase of the market size thresholds or continuing to include UK data in the overall EU trading activity post Brexit) is not feasible. We agree with ESMA's view that "*none of these options appear as legally sound or practicable one.*"[2]

3. Description of current MiFID II exemption for Non-Financial Firms:

Today, Non-Financial Firms remain exempted from a MiFID II licensing requirement as they can apply a two-fold test under the Ancillary Activity Exemption, in conjunction with the current Regulatory Technical Standard (EU Regulation (EU) 2017/592 of 1 December 2016 – hereinafter: „*RTS*"). Non-Financial Firms have to perform these tests and notify their use of the Ancillary Activity Exemption each calendar year:

[2] ESMA MiFID II Review Report on position limits and position management (1 April 2020), p. 39, no. 138.

- Main Business Test (Art. 3 (1) (a) and (b) RTS): Non-Financial Firms can either apply the Trading Turn-Over Test (Art. 3 (1) (a) RTS) or the Capital Employed Test (Art. 3 (1) (b) RTS). The Capital Employed Test, which is used by active commodity trading firms, compares the amount of the capital employed for a Non-Financial Firm's trading activity with the amount of capital employed at group level for carrying out the main business. The share of the capital employed for the trading activity must not be more than 10% so that Non-Financial Firms can make use of the full market size thresholds.[3] This test will work also in a (no-deal) Brexit scenario as it considers the capital employed of the group on a global level, incl. capital employed in non-EU countries (like the UK). Non-Financial Firms, in particular corporates and municipalities who are exclusively hedging their commodity (price) risks, usually apply the alternative Trading Turn-Over Test.[4]
- Market Size Test (Art. 2 RTS): this test compares the size of a Non-Financial Firm's trading activity against the size of the overall trading activity in the EU on a commodity asset class basis, to determine if the market share stays below the defined market size thresholds for each asset class ("*Market Size Test*"). For this purpose, ESMA publishes the EU market size data for each year.

Overall, both tests are relatively complex when compared to exemptions for commodity markets participants in 3rd country jurisdictions (see Annex 2), not only because of their methodology but also because they must be performed and notified each year.

4. Risks triggered by a (no-deal) Brexit scenario

The current methodology for the Market Size Test will not guarantee a sufficient exemption scope for EU27 Non-Financial Firms in the event of a (no-deal) Brexit:

- The reason is that the size of the UK commodity markets will not count towards the EU27 overall market size calculations if the UK leaves the EU without any specific arrangement. This means that trading in certain global commodity asset classes (EU emission allowances (EUA), metal, oil, coal), which are predominately traded on UK commodity exchanges (London Metal Exchange (LME) and ICE Future Europe (ICE)), would then not count towards the EU27 market sizes.[5] In addition, the market sizes for the asset classes gas and power will shrink (in particular UK gas is widely traded on ICE[6]). Furthermore, we strongly believe that trading in

[3] If a non-financial firm exceeds the 10% capital employed threshold, it can make use of only substantially reduced market size thresholds, see Art. 3 (2) RTS.
[4] For these firms this test works also in the context of a (no-deal) Brexit as hedging transactions are not counting as privileged transactions against the market size thresholds.
[5] See EU27 market sized in ESMA MiFID Review Report, p. 38-39, no. 137.
[6] See EU27 market sizes in ESMA MiFID Review Report, p. 38-39, no. 137.

the concerned global commodity asset classes (EUA, metal, oil, coal) will not be migrated to the EU27. One of the main reasons such migration to the EU27 is unlikely to happen is that global customers prefer that LME and ICE remain the liquidity hub for trading these global commodities and that such migration will cause liquidity splits. Therefore, it is unlikely that equivalent and sufficient liquid market places will be developed for these global commodity asset classes in the EU27. However, Non-Financial Firms can't base their business/trading plans and strategies on such potential future developments and can only rely on the current Ancillary Activity Exemption on the basis of the remaining, much lower EU27 market sizes.

- This means that the remaining EU market size for the concerned commodity asset classes (EUA, metal, oil, coal) will be so low that there is a high probability that EU27 Non-Financial Firms' non-hedging trading activities, in particular a few OTC derivative deals, could breach the relevant market size thresholds. ESMA's own quantitative analysis confirms this analysis and, consequently, ESMA states in its MiFID II review report that this "*entails more entities potentially being considered as financial counterparties and no longer eligible to the hedging exemption*".[7]
- This will expose the concerned EU27 Non-Financial Firms to the risk of becoming subject to a MiFID II licensing requirement for the first time, which will trigger burdensome and costly requirements under financial regulation, such as capital and margining/collateralization requirements.
- This is likely to force a number of Non-Financial Firms to curtail or stop their EU trading activity, or, where possible, to trade directly on bilateral OTC markets, or via other international markets, to prevent such costly consequences for their businesses. The resulting fall in liquidity of EU27 commodity markets would significantly increase the costs of risk management for the real economy and severely hamper the ability to hedge commercial risks efficiently. The ultimate net result would be higher end consumer gas and power prices.
- Furthermore, this MiFID II licensing requirement will put EU27 Non-Financial Firms for the first time at a competitive disadvantage vis-à-vis Non-Financial Firms established in 3rd countries, in which no such licensing requirement is present. It will therefore create an unlevel playing field.
- These risks are only mitigated to a limited extent by the following factors. Firstly, the test is based on an average 3-year calculation and, therefore, a breach of a threshold would occur approx. 1-2 years after a (no-deal) Brexit. However, EU27 Non-Financial Firms implement mid to long term fundamental trading and hedging strategies, which means that they usually enter

[7] See ESMA MiFID Review Report, p. 38-39, nos. 137 – 138.

into positions in liquid commodity markets over a period of 2-3 years and, therefore, need planning certainty at an early stage. Secondly, trading on any 3rd country exchange (incl. non-recognised UK exchanges post a (no-deal) Brexit) does not count against the market size thresholds. However, any OTC derivative transaction entered into by EU27 established Non-Financial Firms (also with 3rd country entities) would count against the market size thresholds.

It therefore becomes necessary to review the current Ancillary Activity Exemption for Non-Financial Firms and to replace it by a qualitative Commodity Markets Exemption.

5. Qualitative Commodity Markets Exemption

We believe that the preferable solution would be a *qualitative* Commodity Markets Exemption for Non-Financial Firms, which assesses the nature of the firms' trading activities.

Such a qualitative exemption would provide a simple and robust long-term solution and would ensure that all Non-Financial Firms and commodity asset classes would be treated in a similar manner, creating a level playing field vis-à-vis 3rd countries. A qualitative Commodity Markets Exemption should exempt the same population of Non-Financial Firms and the same activities from a MiFID II licensing requirement as the current Ancillary Activity Exemption.

This can be achieved through relatively simple changes to the Level 1 wording of MiFID II (see Annex 1). The Commodity Markets Exemption would continue to carve-out Non-Financial Firms from the MiFID II licensing requirements, which are trading commodities and commodity derivatives, emission allowances and derivatives thereof on their own account and / or providing financial services to the customers or suppliers of their main business.

The Non-Financial Firms should be able to combine this Commodity Markets Exemption with the other relevant exemptions of Art. 2 (1) of MiFID II, in particular Art. 2 (1) (b) and (d) of MiFID II, to avoid internal commodity price hedging or external treasury finance activities for the wider corporate group triggering a licensing requirement.

In addition to the above-mentioned benefits to exempt Non-Financial Firms from MiFID II licensing requirements (see section 2 above), there are other good reasons in favour of such a qualitative Commodity Markets Exemption:

1) The fact that this exemption can be implemented by the real economy and financial regulators relatively easily could create support for this approach. In particular the burdensome yearly calculation and notification by Non-Financial Firms under the Ancillary Activity Exemption would not be necessary anymore. Furthermore, ESMA would not need to publish market size data and national financial regulators would not need to check if notifications were made (correctly).

2) Based on a comparative regulatory study with regard to 3rd country jurisdictions (USA, Singapore, Switzerland), it becomes apparent that other legal systems have simpler exemptions than in the EU, which – albeit in different ways – lead to an exemption for companies active in trading commodity and commodity derivatives in those 3rd country jurisdictions, in particular when trading on their own account. We are therefore of the opinion that a qualitative exemption in the EU would help to guarantee a level playing field for European companies and maintain the competitiveness of the EU vis-à-vis 3rd countries.

3) This test creates more legal certainty, in particular for small and medium sized firms ("SME") and natural persons. In practice many SMEs and natural persons, like farmers and small producers of goods who use commodity derivatives to hedge their commercial risks are often not aware of the MiFID II provisions and consequently do not make the necessary calculations and notifications under the Ancillary Activity Exemption. This exposes SMEs and natural persons to the risk of breaching the MiFID II licensing regime and becoming subject to penal and/or administrative sanctions. As this exemption would apply by law and would not require a notification, this legal risk would not exist anymore and would relieve national financial regulators from their surveillance and enforcement obligations accordingly.

4) The fact that it would not impose any quantitative limits on the amount of non-hedging activities will be addressed by already existing regulatory mechanisms: the clearing threshold for commodities under EMIR and the resulting clearing and margining obligations for Non-Financial Firms above this threshold (so-called NFCs+). These, as well as the existing commodity position limits, sufficiently address regulatory concerns with regard to (non-hedging) commodity trading activities.

***