Commissioner Mairead McGuinness
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

27 November 2020

Dear Commissioner McGuinness,

Brexit – recognition of UK commodity exchanges under EMIR Art. 2A

The undersigned associations strongly recommend that the European Commission determines that UK commodity exchanges are equivalent to EU regulated markets under the provisions of EMIR Article 2a to avoid widespread disruption and undue burdens on EU firms following the end of the Brexit transition period on 1 January 2021.

The reclassification of exchange traded derivatives (ETDs) traded at UK exchanges as over-the-counter (OTC) derivatives will lead to EU firms facing a stark choice between meeting costly and burdensome mandatory central clearing and collateralisation obligations under EMIR or restricting their business and risk management activities. As industry continues to struggle with rapidly changing global demand in energy and highly volatile commodity markets induced by the COVID-19 pandemic and its economic consequences, these additional burdens will drive higher costs for industry and higher power and gas prices for consumers. We explain these consequences in more detail in the following paragraphs to highlight the need for EU market participants to maintain continued and unhindered access to global commodity markets.

Reclassification of Exchange Traded Derivatives (ETDs) traded on non-equivalent third country venues as OTC Derivatives

In the absence of an equivalence decision under EMIR Article 2a, derivatives traded on UK regulated markets that are currently categorised as ETDs, will be re-categorised as OTC derivatives after the end of the Brexit transitional period (31.12.2020). This means that EU

firms will enter into OTC derivatives transactions when they trade over UK regulated markets after the end of the transition period.

The European Commission referred to this re-characterisation in its Notice to Stakeholders 'Withdrawal of the United Kingdom and EU rules in the field of post-trade financial services':[1]

> *As of the withdrawal date, derivatives traded on a UK regulated market will no longer fulfil the definition of exchange traded derivatives (ETDs) under EU law. According to Article 2(32) of MIFIR, ETDs are derivatives traded on an EU regulated market, or on a third-country market considered to be equivalent. Thus, under EU law, as of the withdrawal date, ETDs traded on a UK regulated market will be over-the-counter (OTC) derivative contracts.*

The European Securities and Markets Authority (ESMA) reinforced this view in the EMIR Questions and Answers[2] explaining that only derivative contracts executed on a third-country market which are considered equivalent to an EU regulated market by the European Commission in accordance with EMIR Article 2a, are not OTC derivatives under EMIR and do not count for the purpose of the determination of the clearing threshold under EMIR Article 10.

ESMA goes on to explain that derivative contracts executed on third-country regulated markets which are not deemed equivalent to an EU regulated market, will count towards the determination of the EMIR clearing threshold under EMIR Art. 10, because they are re-characterised as OTC Derivatives.

Adverse consequences of missing recognition of UK regulated markets for EU firms

The lack of equivalence for UK commodity exchanges under Art. 2a of EMIR has the unintended effect of exposing EU companies to the risk of exceeding the EMIR clearing threshold of €3 billion for commodities ("EMIR CT"), which will trigger several burdensome requirements.

Today, the vast majority of EU non-financial counterparties (NFCs) that use energy and commodity derivatives markets do not exceed any of the EMIR CTs and qualify as so-called "NFC minus" (NFC-) counterparties and thereby avoid the mandatory clearing and collateralisation requirements imposed by EMIR.

The re-characterisation of UK ETD trades as OTC trades may result in EU NFCs- active on energy and commodity derivatives markets breaching the EMIR CT in the commodity asset class. The most burdensome obligation for EU non-financial firms which breach the EMIR CT (so-called "NFC plus" (NFC+), would initially be the obligation to post bilateral margins (collateralisation) for all uncleared OTC derivative transactions. NFCs+ will also be subject to a mandatory clearing obligation for all OTC commodity derivatives, across the entire corporate group, once a clearing obligation for commodity derivatives has been introduced by means of a Regulatory Technical Standard.

For these reasons, EU companies will be forced to reduce their trading activities on UK commodity exchanges to avoid breaching the EMIR CT. This will likely result in substantial limits on EU companies and, consequently, hinder their risk management capabilities as well as their business opportunities and further development in global markets.

The adverse incentive to reduce their trading activities on UK exchanges is mainly triggered by the high cost of bilateral margining. Unlike the clearing obligation - which is ring-fenced to the asset class where the threshold is breached – the collateralisation obligation applies to all OTC derivatives asset classes including OTC foreign exchange and interest rate across the entire corporate group. The cost of posting collateral running into tens of billion Euros to cover

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[1] European Commission Notice to Stakeholders on "Withdrawal of the United Kingdom and EU rules in the field of post-trade financial services" dated 8 February 2018

[2] ESMA Q&A ON EMIR IMPLEMENTATION dated 24 September 2020, p. 16

these margins is huge and will have a drastic negative impact on the cash flow in most corporate groups.

European real economy firms would also lose unfettered access to the huge liquidity pools on UK commodity exchanges. Some UK commodity exchanges host the most liquid venues in various commodities, which EU companies use to properly address and reduce their commercial risks. This places EU firms at a competitive disadvantage to UK and other third-country firms solely based on an artificial regulatory necessity for EU firms to avoid breaching the EMIR CT. To avoid a similar situation for UK firms, the UK Government has already announced its intent to provide equivalence decision for EU trading venues under Art. 2a UK EMIR[3] following the end of the Brexit transitional period. Hence, UK firms will be able to consider EU trading venues as regulated markets under Article 2a of UK EMIR and do not need to take any further action to benefit from this decision.

EU firms have no effective means to mitigate these impacts by relocating their trading activities. While EU firms have some limited ability to move some trading activity to EEA markets or already qualified third-country trading venues (e.g., USA) to avoid breaching the EMIR CT, this will not be feasible for markets in global commodities such as metals, oil, coal and gas which rely on broad international participation and liquidity providers and which will remain in the UK. It should be noted that ICE Futures and LME will not move their global commodity business to the EU because of their global membership bases.

Moving trade to third-country venues (e.g., to the US) also involves burdensome operational workflows (e.g. re-papering) and triggers third-country compliance obligations for non-financial counterparties, while at the same time causing the disappearance of commodity markets from Europe.

Negative effects on the larger EU economy

The additional costs of meeting EMIRs obligations would impose considerable additional cost on EU companies without any known benefits during a time of unprecedented challenge for the EU and global economy. The costs of increased margining and clearing will spill over to the wider EU economy as reduced liquidity and increased prices for commodities and commodity derivatives adversely affect economic activity across the EU. In particular, the energy, metals and chemical sectors are affected directly and consumers face higher energy and product prices as a result.

Equivalence determination is the solution

The solution is for the European Commission to determine that the UK commodity exchanges (LME and ICE) are equivalent to EU regulated markets under Article 2a EMIR[4]

To avoid these massive adverse and inadvertent consequences to EU businesses and markets from the re-classification of ETDs traded over UK exchanges, we urge the European Commission to recognise UK commodity exchanges under EMIR Article 2a before the end of the Brexit transitional period.

[3] FCA responds to Treasury announcement on equivalence, dated 9 November 2020

[4] REGULATION (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories - Article 2a Equivalence decisions for the purposes of the definition of OTC derivatives

CC:

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European Commissioner for Energy, *Kadri Simon*;

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Chief Negotiator - Task Force for the Preparation and Conduct of the Negotiations with the United Kingdom, *Michel Barnier*.

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