Deutsches Aktieninstitut

ESMA's work on MiFID II/MiFIR

Rules should reflect adequately the need of companies to finance and to hedge businesses

Comment of Deutsches Aktieninstitut, 20 February 2015

Summary

The rules under MiFID II/MiFIR and ESMA's proposed technical advice and regulatory standards should not hamper companies' need to finance their business and to hedge risks stemming from their commercial or treasury financing activities. In addition, obstacles for retail investors to invest in shares or other capital market instruments should be dismantled. Deutsches Aktieninstitut[1] is of the opinion that recognising these two guiding principles is also a prerequisite for a consistent implementation of a Capital Markets Union which the EU Commission has identified as a major source for growth and innovation in the EU.

This position paper includes our assessment of the ESMA's final report regarding the technical standards. It also reflects an assessment of specific details ESMA proposes in its recently consulted draft technical standards. We will detail our arguments in our response to the respective ESMA consultation.

Concretely, Deutsches Aktieninstitut proposes the following:

1. The prohibiton of inducements should not impact negatively research coverage of small and medium-sized enterprises
2. Clients receiving investment advice should have the option to waive the documentation requirements
3. Contracts for the effective delivery of commodities should not be in the scope of the definition of financial instrument
4. The ancillary activity exemption for non-financial companies should adequately reflect common risk management practices of non-financial companies
5. Position limits and position reporting should be appropriate
6. The transparency regime regarding derivatives should appropriately take into account the specifics of derivatives used by non-financial companies

[1] Deutsches Aktieninstitut (identification number: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt, Brussels and in Berlin.

1 Issues included in ESMA's technical advice

1.1 Suitability report

According to Art. 25(6) MiFID II the investment firm shall provide the client with a statement on suitability („suitability report") before the transaction is entered into. Art. 25(8) MiFID II empowers the Commission to adopt delegated acts specifying inter alia Art. 25(6) MiFID II. In the Commission's request for technical advice ESMA is mandated to provide proposals for the content of suitability reports aiming to ensure a real added value for the clients.

In its technical advice ESMA has taken into account the ***"frequency of the transaction"*** for periodic investment advice the client is involved in. The Commission should provide ***experienced*** retail clients (e.g. those customers who received an investment advice five times in the last two years) the option to waive the reporting requirement in case the customer is frequently receiving periodic suitability assessments/reports and single investment advices. This ensures a ***"real added value"*** for the clients as required by the Commission.

Experience with the German "Beratungsprotokoll" (investment advice minutes which could be regarded as equivalent to the suitability report) shows that the formalized process to record the investment advice is very time-consuming. Especially those retail clients frequently advised by banks have difficulties to see the benefit of the documentation procedure. They complain about the additional time consumed and would prefer to waive this obligation individually – unfortunately, they are not allowed to do so.

In this regard our proposed waiver is justified and should not be confused with the ***waiver granted e.g. for the transparency requirements under MiFIR***. What we propose is not a *general* waiver for every transaction under well defined conditions, which is the case for the transparency waiver. Our waiver should leave experienced clients the option, to renounce their right to receive the suitability report after a certain amount of investment advices. This option should be granted to the client in a transparent and comprehensible form.

In addition, due to the documentation requirement banks have to devote a huge amount of financial and human resources to implement the respective processes. As unintended side effect many (especially smaller) banks abandoned its investment advice in shares completely and others reduced their investment advice in

shares significantly. This is evidenced by a survey conducted by Deutsches Aktieninstitut among German banks in July 2014. Regulation is also the reason why banks retreat from investment advice in other securities like bonds and investment funds.

The development that banks refrain from share recommendations will further harm equity culture among retail investors, which is already underdeveloped in the EU compared to other jurisdictions like the US. The result is a severe damage for the private wealth building by equity instruments especially at a time when investments in fixed income instruments hardly yield above the inflation rate. This is a further reason that the proposed possibility for experienced clients to waive the documentation requirement takes proper consideration of the over-arching aim of MiFID "investor protection".

Last but not least, financing SMEs by issuance of shares purchased by retail investors will become more difficult as banks are increasingly reluctant to provide information regarding share investments. This contradicts the approach of the Commission to improve the access to capital markets especially for SMEs ("Capital Markets Union").

1.2 Research

According to Art. 24 of MiFID II persons providing portfolio management and investment advice on an independent basis should only accept minor non-monetary benefits. In this context ESMA prohibits the widespread practice to pay for research as part of the execution commissions. It would be only admissible to pay for research by charging the client directly through the introduction of a separate research budget or by raising management fees.

As the environment in the funds industry is highly competitive, it would be difficult to pass on research costs directly to clients. As a result the demand for research by investment managers will become more selective. It is very likely that especially the demand for SME research will decrease which will aggravate the problem of these companies to become "visible" on capital markets and to attract more investors. This also contradicts the aim of the Commission to improve access to capital markets especially for SMEs.

Furthermore, it is not obvious why research paid by dealing commissions raises concerns regarding conflicts of interest. The choice that transactions are to be executed by a certain broker depends on the amount of execution commissions ("best execution"). With this regard, investment managers are obliged to choose the broker with the cheapest offer to execute the orders. The availability of research or other "soft commissions" should not be relevant. Notwithstanding, in cases where

the broker provides research as an additional service it is in the interest of the client that the investment manager mandates this broker, given his dealing commissions are the cheapest compared to the competitors.

In addition, with the implementation of MiFID II clients will get transparency about the costs the investment manager spends for research as these costs are obliged to be disclosed according to Art. 24(4) MiFID.

1.3 Definition of commodity derivatives

The definition in annex 1, section C 7 MiFID II refers to "options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 of this Section and not being for ***commercial purposes***, which have ***the characteristics of other derivative financial instruments***."

We are concerned that "normal" supply contracts for the delivery of commodities like electricity, gas, oil, agriculture products etc. used by the real economy for their operative businesses could be covered by the definition and hence be classified as derivatives. This could be the case for contracts where the price for the commodities agreed between the buyer and the seller is linked to market prices / indices determined on exchanges or which display other standardised items.

The reason for our concern is that the definition in C7 is very broad:

- According to the "standardisation criterion" contracts are regarded as financial instruments if they refer to regularly published prices, standard lots or standard delivery dates.
- According to the "trading criterion" contracts are regarded as financial instruments if they are equivalent to contracts traded on a regulated market, MTF or OTF or a comparable third country trading venue, with regard to the price, the lot, the delivery date or other terms.

Both criteria might apply to the abovementioned supply contracts.

Nevertheless, these contracts do not display characteristics of financial instruments as their main object is the ***effective delivery*** of commodities for commercial purposes. Unfortunately, these contracts are not covered by the "commercial purposes test" as the test is very narrowly defined and limited to "an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network and it is necessary to keep in balance the supplies and uses of energy at a given time".

Therefore, the definition has to be reshaped:

- For the ***commercial purpose test*** the ***UK legislation*** could be a role model. The legislation includes explicit provisions for indications to be used to evaluate whether a contract is meant for commercial purposes, namely: (a) where one or more of the parties is a producer of the commodity or other property, or uses the commodity in its business; (b) the seller delivers or intends to deliver the commodity or the purchaser takes or intends to take delivery of it.

  As an alternative, reference could be made to the ***already existing criterion under EMIR*** which objectively and already well-proven defines the term commercial activity (see Art. 10 of Commission Delegated Regulation (EU) No 149/2013).

- We think that the Commission should focus mainly on the commercial activity test as this is of most relevance for the real economy. Nevertheless, we also propose to extend the "trading criterion" in such a way that equivalence to contracts traded on a trading venue is only given when the respective contracts display identical characteristics with regard to regularly published prices, standard lots ***and*** standard delivery dates compared to contracts already traded.

2 Issues included in ESMA's draft technical standards

2.1 Exemption for ancillary activities

Art. 2(1)(j) MiFID states that non-financial companies using commodity derivatives, emission allowances and derivatives thereof are – inter alia – not required to be licenced under MiFID as investment firm if their trading in these instruments is an ancillary activity.

For the following reasons we think that the proposals of ESMA made in the consultation document are problematic:

- ***Thresholds:*** ESMA proposes two thresholds for the ancillary activity test: The capital employed which should not exceed 5% of the capital employed on group level and the trading activity which should not exceed 0.5% of the overall market trading activity in the respective asset class. The thresholds are very low and we are concerned that major market participants will leave the market with unintended consequences for the liquidity. As a result, bid/offer spreads and hence prices for the respective instruments will rise, to the detriment of end-users.

  In addition, ESMA does not provide an empirical analysis of how these thresholds are derived. Therefore, we urge ESMA to conduct a sound analysis on the basis of the data available in trade repositories (according to the derivative regulation EMIR all counterparties are obliged to report their derivatives traded on-venue and OTC). This data should be considered in order to adequately calibrate the thresholds. Without a thorough impact analysis ESMA should set the thresholds on a higher level to avoid unforeseen, unintended consequences.

- ***Privileged transactions:*** Emission allowances required to be held by law (especially due to the requirements of the European Emission Allowances System) should be – like risk-mitigating derivatives – acknowledged as privileged transactions as well. These transactions could be easily identified as they are classified as "own use" instruments under the accounting rules.

- ***De minimis exemption:*** According to a proposed "de minimis exemption" non-financial companies not exceeding a market activity threshold of

0.25 % are not required to calculate the second threshold regarding the capital employed. Although the threshold should be increased as well, this exemption is very helpful and should be preserved in general. To allocate capital for certain activities or transactions is a notion only common for financial institutions complying e.g. with capital/own fund requirements, or commodity firms with separate trading entities. However, this is not the case for most other non-financial companies. The MiFID requirement to assume allocated capital for certain activities would cause an additional administrative burden which is not justified especially for companies far away from exceeding the thresholds (as they are using derivatives almost exclusively for risk mitigating purposes). The de minimis exemption is also covered by the level-1-text as Art. 2(4) only states that ESMA "***may*** determine that the capital employed […]", which is not excluding alternative solutions.

- ***Calculation of the trading activity test:*** It is unclear if ESMA intends to provide data especially regarding the overall market activity. The latter is necessary as market participants do not have access to all existing trade repositories to calculate the respective figures. Therefore, figures regarding the overall market activity in the respective asset classes should be provided centrally by ESMA or the national supervisory authorities which have access to the data collected on trade repository levels.

2.2 Position limits for commodity derivatives

According to Art. 57 MiFID competent authorities are required to apply position limits for commodity derivatives. Derivatives of non-financial companies which are objectively measurable as reducing risks directly relating to the commercial activity are exempted from the position limit regime. We welcome the aim of ESMA to refer to the definition for "risk-reducing" already available under EMIR.

However, regarding the discussion initiated by ESMA in the consultation paper according to ***macro, portfolio or proxy hedging*** it should be clearly stated that these widespread risk-mitigating instruments are acknowledged as "risk-mitigating" under the position limits regime as well. On the one hand, ESMA notes that there is a clarification in the EMIR Q&A on what constitutes macro, proxy or portfolio hedging (see OTC Q10(c)). We think the latter is a clear statement for the intention of ESMA to follow the hedging definition which is already available under EMIR and detailed by the respective Q&A under the position limit regime as well.

On the other hand, ESMA does question the applicability of macro hedging when it comes to the position limit regime, and has deleted the term "directly or through closely correlated instruments" coming from the EMIR hedging definition in Art. 1

para.1 (s. RTS 30 on p. 395) of the respective draft technical standards. Please compare Art. 10 of Commission Delegated Regulation (EU) No 149/2013: "An OTC derivative contract shall be objectively measurable as reducing risks directly relating to the commercial activity […] of the non-financial counterparty or of that group, when, *by itself or in combination with other derivative contracts,* ***directly or through closely correlated instruments,*** it meets one of the following criteria […]". Therefore, in order to bring the hedging exemption under the position limit regime unambiguously in line with the hedging definition under EMIR the term "directly or through closely correlated instruments" should be introduced in Art. 1 para. 1 of draft RTS 30.

Furthermore, the proposed ***notification process*** for the hedging exemption is too complex and does not reflect risk management practice. The proposal of ESMA could be read as a requirement for companies to wait up to 30 days until each single transaction is acknowledged by the competent authorities as "risk mitigating". This would be not appropriate, as it is inconceivable to delay hedging decisions for longer periods. Besides that, filing individual transaction applications seems inefficient given the significant number of deals some corporates need to transact due to their operative needs. Therefore, in the interest of both market participants and competent authorities the notification process for the hedging exemption should be designed much leaner, and in aggregated form (e.g. weekly or monthly summary).

One possible solution: Reference could be made to reports provided by the relevant EMIR trade repositories which already include the information given by the company whether the derivative in question is for risk-mitigating purposes or not. This report could be flagged and directly submitted by the trade repository to the competent authority. Hence, a separate notification in order to apply for the hedging exemption under the position limit regime would be superfluous.

2.3 Position reporting

Double reporting under Art. 58 MiFID II should be avoided by coherent reporting standards between different regulations, especially regarding EMIR. ESMA should be aware that the compliance with the reporting obligation under EMIR is very burdensome for every market participant. Additional reporting requirements regarding positions in commodity derivatives and emission allowances resp. derivatives should be avoided. Therefore, the obligation for end-users to report their positions daily to the venue operator should be kept as lean as possible. This means that data already available should be used to a large extent.

According to EMIR, commodity derivatives and derivatives on emission allowances (recently according to the respective definition under MiFID I and in future under MiFID II) have to be reported to trade repositories. For these instruments ESMA or the venue operator should tap the information already available in the trade repositories. This information is sufficient to calculate and update the respective positions of every end client in the respective derivative instruments. A further reporting requirement for end clients would be absolutely superfluous.

Data for the positions in emission allowances is available as well: In Germany the German Emissions Trading Authority (see http://www.dehst.de/EN/Home/home_node.html) collects data according to the emission allowances and the positions each company holds in these instruments. These sources should be used for position reporting.

2.4 Transparency for non-equity instruments / derivatives

The transparency requirements for derivatives could seriously interfere with the risk management strategy of non-financial companies using tailor-made or bespoke derivatives. Therefore, the peculiarities of these derivatives should be reasonably reflected by the transparency regime.

In some cases, especially for large orders or orders referring to a illiquid underlying, transparency would have negative impacts on the price formation process. To avoid an impact on prices these orders are commonly split into smaller buckets. Given that these transactions are made transparent orders executed at a later stage will become remarkably more expensive. The reason for this is that it is unlikely that a "bespoke" derivative is demanded by various end-users at the same time. The supply side can therefore conclude that the split orders can be attributed to one and the same end-user. As a result, prices will increase which makes risk management more expensive.

These particularities of derivatives used by non-financial companies are already adequately reflected in the pre-trade transparency regime in Art. 8(1) MiFIR (the respective pre-trade transparency on venues does not apply for derivative transactions of non-financial counterparties which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity).

Furthermore, recital 1 and recital 5 of the draft RTS 9 clearly state that the transparency requirements should ensure that investors are adequately informed and that primary market transactions should be excluded from the provisions of this regulation. Derivatives used by non-financial companies for risk-mitigating pur-

poses are by and large not fully fungible, standardized instruments. They are contracts bilaterally agreed with their banking partners. If the customer wants to get out of the position, it will not be transferred to someone else, e.g. an investor, but closed out. Secondary markets with "active" investors do not exist for the derivatives described above. ***Therefore, ESMA should unambiguously state that those derivatives which are not traded on a secondary market are excluded from the transparency requirements.***

At least, details proposed by ESMA for deferred post-trade publication should be adjusted:

- 48 hours for the deferral period for transactions which are illiquid, large in scale or above the size specific for the instrument are too short. The deferral period should be extended to 5 days after the day of the execution at the minimum.
- ESMA proposes that competent authorities should have the option that other details besides those relating to the volume should be revealed immediately. ESMA should be aware that these details are highly relevant and will impact the pricing process as described above. If the underlying itself is illiquid, e.g. an emerging market currency, or a comparatively long maturity, the customer is at risk to be taken advantage of by traders even without mentioning the requested volume. A waiver, especially when temporary, should not reveal selective information, or it is superfluous from the very beginning. Therefore, these details should not be published during the deferral period, which is also the approach chosen by the U.S. CFTC. Otherwise, the level playing field between the U.S. and the European industry would be challenged.

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