CMC Europe – Draft answers to MiFID 2 CP questions

Draft RTS 28 for Article 2(4) MiFID 2 (Ancillary Activity)

Q168. Do you agree with the approach suggested by ESMA in relation to the overall application of the thresholds?

CMC Europe does not agree with the approach suggested by ESMA.

- Data that ESMA bases itself on is insufficient- consequences of the thresholds are completely unpredictable
- The thresholds set would make majority of commodity trading firms subject to CRD4/CRR, EMIR – most likely not only those engaging in commodity derivatives for purposes other than hedging – resulting in less liquidity in the market and higher prices for end-consumers
- If intermediary market moves away due to regulatory and capital constraints, producers of commodities may start to experience difficulties in hedging and bear increased risk
- Commodity traders do not have access to central bank liquidity like many others caught by CRD4
- Market participants in financial derivatives other than commodities and emission allowances, e.g. equity derivatives, can make use of the propriety trading exemption (art 2.1.d), irrespective of whether trading is done as hedging or is speculative. Why are commodities treated so differently?
- Third countries: ESMA proposal seems to discriminate against firms with no EU branch – these should be allowed to apply for the ancillary exemption

Q169. Do you agree with ESMA's approach to include non-EU activities with regard to the scope of the main business?

Yes, CMC Europe finds this an appropriate approach.

Q170. Do you consider the revised method of calculation for the first test (i.e. capital employed for ancillary activity relative to capital employed for main business) as being appropriate? Please provide reasons if you do not agree with the revised approach.

Yes, we do. CMC Europe has in the past advocated to include any capital employed for risk management purposes and welcomes the revised method of calculation.

- We note that there is a ‘capital’, but no ‘capital employed’ definition.

Q171. With regard to trading activity undertaken by a MiFID licensed subsidiary of the group, do you agree that this activity should be deducted from the ancillary activity (i.e. the numerator)?

CMC Europe agrees that this should be deducted from the ancillary activity.

- Activity undertaken by a subsidiary of the group that can invoke another article 2 exemption should perhaps also be deducted from the numerator.

Q172. ESMA suggests that in relation to the ancillary activity (numerator) the calculation should be done on the basis of the group rather than on the basis of the person. What are the advantages or disadvantages in relation to this approach? Do you think it would be preferable to do the calculation on the basis of the person? Please provide reasons. (Please note that altering the suggested approach may also have an impact on the threshold suggested further below).

We are broadly supportive insofar as the group in this case is the person seeking the exemption and the wholly owned subsidiaries of that person or controlled by that person.

This should not include fellow subsidiaries of a mutual parent, intermediate or ultimate holding company and in this regard, follow the approach proposed by ESMA on the application of position limits.

CMC Europe cautions that the reference to group as defined in the Accounting Directive is confusing.

- What happens if only one entity within a group exceeds the threshold? Would all other entities within the group need to get a MiFID II license? Whereas ESMA suggests that a group can establish a subsidiary in which all MiFID activities are bundled so as to avoid this? A useful clarification would be that the person exceeding the thresholds will need to be MiFID licensed, whereas MiFID II does not apply to those entities of a group that are not undertaking any non-privileged or non-MiFID II transactions.

Q173. Do you consider that a threshold of 5% in relation to the first test is appropriate? Please provide reasons and alternative proposals if you do not agree.

CMC Europe does not consider this appropriate and thinks a 5% threshold is particularly low.

- How did ESMA arrive at this figure, given CP responses?
- Does not leave room for any calculation errors
- We are mindful that the persons that should be able to use the ancillary activity exemption deal with volatile markets with significant margin requirements which vary with foreign exchange rates and with commodity prices. (oil price example?)
- Concerns when a firm's global capital is measured in one currency and traded contracts in another
- Could ESMA adopt fluid thresholds instead, starting with a high threshold in 2017 lowered over time- similar to CFTC step-down approach?
- We advocate 15% instead, as per our drafting suggestions below.

Article 2 **Application of the thresholds** An activity shall be considered to be ancillary to the	**Article 2** **Application of the thresholds** An activity shall be considered to be ancillary to the

main business in accordance with Article 2(1)(j) of Directive 2014/65 EU: (a) if the capital employed by the group for carrying out eligible activity in the European Union accounts for less than 5% of the capital employed for carrying out the main business of the group in the European Union and in third countries; and (b) if the size of the trading activity (i) in commodity derivatives of the group undertaken in the European Union accounts for less than 0.5% of the overall market trading activity in the European Union in one of the following asset classes: 1. metals; 2. oil and oil products; 3. coal; 4. gas; 5. power; 6. agricultural products; or 7. other commodities, including freight and commodities referred to in Section C 10 of Annex I of Directive 2014/65/EU; or (ii) in emission allowances or derivatives thereof of the group undertaken in the European Union accounts for less than 0.5% of the overall market trading activity in the European Union.	main business in accordance with Article 2(1)(j) of Directive 2014/65 EU: (a) if the capital employed by the group for carrying out eligible activity in the European Union accounts for less than 5% of the capital employed for carrying out the main business of the group in the European Union and in third countries; and (b) if the size of the trading activity (i) in commodity derivatives of the group undertaken in the European Union accounts for less than 0.5% of the overall market trading activity in the European Union in one of the following asset classes: 1. metals; 2. oil and oil products; 3. coal; 4. gas; 5. power; 6. agricultural products; or 7. other commodities, including freight and commodities referred to in Section C 10 of Annex I of Directive 2014/65/EU; or (ii) in emission allowances or derivatives thereof of the group undertaken in the European Union accounts for less than 0.5% of the overall market trading activity in the European Union.
Article 3 **Calculation of the capital employed** 1. The capital employed for carrying out the eligible activity shall be calculated by deducting from the sum of the capital employed for eligible activity by the group in the European Union the sum of the capital employed for privileged transactions by the group in the European Union. Capital employed for trading activity undertaken by an entity of the group that holds a license in accordance with Article 5 of Directive 2014/65/EU shall not be considered when calculating the capital employed for the eligible activity. 2. The capital employed for carrying out the eligible activity calculated in accordance with paragraph (1) shall be divided by the capital	**Article 3** **Calculation of the capital employed** 1. The capital employed for carrying out the eligible activity shall be calculated by deducting from the sum of the capital employed for eligible activity by the group in the European Union the sum of the capital employed for privileged transactions by the group in the European Union. Capital employed for trading activity undertaken by an entity of the group that holds a license in accordance with Article 5 of Directive 2014/65/EU shall not be considered when calculating the capital employed for the eligible activity. 2. The capital employed for carrying out the eligible activity calculated in accordance with paragraph (1) shall be divided by the capital

employed for the main business of the group in the European Union and in third countries.	employed for the main business of the group in the European Union and in third countries.

Q174. Do you agree with ESMA's intention to use an accounting capital measure?

CMC Europe broadly agrees to this as it is easier to use accounting capital that economic capital measures.

Q175. Do you agree that the term capital should encompass equity, current debt and non-current debt? If you see a need for further clarification of the term capital, please provide concrete suggestions.

CMC Europe finds including equity, current and non-current debt reasonable, but warns that it is not easy to divide across the size of trading activity.

- Would margin payments need to be added?
- FIA Europe members propose to use a separate definition of 'working capital' for the purposes of calculating capital employed for 'risk reducing transactions' on the aggregate of mark to market values for uncleared OTC risk reducing transactions; accounts receivables and accounts payables (netted) in respect of risk-reducing transactions; initial margin posted or received for exchange traded and/or cleared risk reducing transactions.

Q176. Do you agree with the proposal to use the gross notional value of contracts? Please provide reasons if you do not agree.

'Gross notional contract' is an OTC derivative term. Lot x price – value is always going to be function of current price.

- Gross notional values should be used both in nominator and denominator
- Whilst the notional value amount is a reportable field under EMIR, the gross notional value is not. ESMA might need to clarify how it will ensure this data is available.

Q177. Do you agree that the calculation in relation to the size of the trading activity (numerator) should be done on the basis of the group rather than on the basis of the person? (Please note that altering the suggested approach may also have an impact on the threshold suggested further below)

See answer 172. [FIA Europe recommends amending RTS 28 to state that only the person exceeding the thresholds will need to be MiFID II licensed whereas other group activities remain outside the scope of MiFID II.

Q178. Do you agree with the introduction of a separate asset class for commodities referred to in Section C 10 of Annex I and subsuming freight under this new asset class?

- Granularity of the asset classes is a concern as it ultimately makes it easier to breach threshold
- C10: should not create an artificial commodity class with very limited market participants- could create disproportionate outcomes.

- The proposed use of the Section C10 of Annex 1 categorization leaves freight in the position of being in effect a category on its own, or very nearly so. It is difficult to establish volume figures for the trading of climatic variables and inflation rates and other official economic statistics. However ESMA has now published the Addendum Consultation Paper (ACP) which indicates that based on its own analysis, freight will represent 57% of the Annex 1 C10-based segment.

- The effect of the creation of a segment in which freight sits more or less on a stand alone basis is extremely prejudicial to the shipping market and to the freight derivatives market as the application of all of the thresholds (0.25%, 0.5% and 5%) has a far greater impact when this already small and ancillary market is set apart from others.

- Many commodity companies have a significant exposure to freight costs which they manage through the freight derivatives market. However, the nature of the market is that the hedging transactions are unlikely to meet the stringent tests set out in EMIR. It is therefore likely that significant numbers of companies which are using freight derivatives as a risk management tool (and a small proportion of their overall activity) will become financial entities, purely on the basis of their freight risk management. This makes no sense.

- The trigger for a commodity trading house to become a financial entity should surely be based on the aggregate derivatives activity of the group, or the largest commodity category in which the company operates.

- It would be particularly unfortunate if freight were to be the trigger for an otherwise exempt commodity house to become a financial entity since it is in any case ancillary to all other activities. Freight does not exist as a commodity on its own. It is strictly speaking a service and it can certainly only exist in conjunction with the commodity being carried.

- CMC Europe has considered a number of alternative proposals which ESMA could adopt to solve this problem.

- The core problem is the relatively inflexible definition of hedging activity under EMIR, which is being re-used here. The best solution therefore is to re-work this definition to allow all portfolio hedge transactions to be properly considered as hedging. We would still be uncomfortable with the current categorisation however.

- As an alternative the problem could be overcome by significantly changing the volume threshold for the freight market to say 20%. The capital threshold would also need to be altered to at least 50% of group capital, recognising the very high margins charged by the clearing houses in this market

- A pragmatic solution is to move freight into one or more different categories. This would recognise that freight remains a service which is ancillary to commodity businesses. There are a number of ways of implementing this general solution. Recognising that most dry bulk derivatives trading is in the capesize market and linked to the steel complex, dry bulk freight could be added to the metals or possibly the coal segment, while wet bulk freight could be added to the oil and oil products market.

- I.e. suggestion could be to make asset classes metals (+freight), oil and oil products (+freight), energy (+freight), ags (+freight).

Q179. Do you agree with the threshold of 0.5% proposed by ESMA for all asset classes? If you do not agree please provide reasons and alternative proposals.

CMC Europe strongly disagrees with the proposed 0.5% threshold and would propose a 10% threshold for oil and oil products; metals; agricultural products and coal; and a 20% threshold for freight, as a separate standalone asset class. For other C10 asset classes we suggest 20%; for emissions 30%.

- Could we consider CFTC approach, where Swap Dealer threshold is set higher initially for markets and participants to adapt and evolved at a more measured pace?

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Q180. Do you think that the introduction of a de minimis threshold on the basis of a limited scope as described above is useful?

Yes, CMC Europe thinks a de minimus threshold for small and medium sized entities is useful. However, at 0.25% the threshold is set too low and we would suggest a 5 per cent threshold instead.

- Even small firms that only hedge might not be able to use exemption
- Calculation of market share is complicated; errors will have an immediate impact
- Could there be a flexible threshold percentage?
- Also, the de minimus test is not currently in RTS 28 and would need to be specified and added.

Q181. Do you agree with the conclusions drawn by ESMA in relation to the privileged transactions?

No, CMC Europe does not agree to the ESMA's conclusions on privileged transactions.

ESMA must be able to infer within its definition an accommodation or other for emission allowances held exclusively for compliance with the ETS Directive. While there is no express direction for this in article 4 (2) MiFID II, there is no other way to account for this market. If you cannot accommodate emission allowances held for compliance purposes, then the rest of the ancillary activity exemption is irrelevant.

- ESMA relies on the definition of intra-group transactions in Art.3 of EMIR but this is subject to change
- Can intra-group transactions with subsidiaries or branches in different jurisdictions be taken into account for the deduction?

Q182. Do you agree with ESMA's conclusions in relation to the period for the calculation of the threshold? Do you agree with the calculation approach in the initial period suggested by ESMA? If you do not agree, please provide reasons and alternative proposals.

We agree to these conclusions, but with reservations. We cannot be expected to unwind positions or seek authorisations at the end of 2016; a 12-month phase in period would be needed.

- Could a fluid threshold approach be considered, taking into account the fact that no market participant will be able to rely on the ancillary exemption on 3 January 2017 due to a lack of market data until 31 December 2016?