Commodity Markets Council - Europe

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September 2020

To: Mr. Paul Rich / Ms. Hillary Neale, Strategic and Cross-cutting Policy Division, Financial Conduct Authority

Transmitted via electronic mail

Re: DP20/2: Prudential requirements for MiFID investment firms

Dear Mr. Rich,
Dear Ms. Neale,

I am writing to submit comments by the Commodity Markets Council Europe (CMCE) in response to the FCA Discussion Paper 20/2 on Prudential requirements for MiFID investment firms.

CMCE is an industry association comprised of agriculture, energy, metals and other commodity market participants, price reporting agencies and commodity exchanges. CMCE's commodities firm members are established and/or operating in the EU, the EEA and Switzerland, including a number of firms that are established and/or regulated in the UK.

Overall approach for commodity dealer investment firms

We welcome the FCA's intention to amend the regime under the EU Investment Firm Directive and Regulation (IFD/IFR) to suit the specificities of the UK markets now that the UK has left the EU. In this respect, we believe that there is a case to be made for more proportionate treatment of commodities investment firms under the future UK regime for prudential requirements for MiFID investment firms.

The new EU regime under the IFD/IFR largely applies to commodity and emission allowance dealers in the same way as to other MiFID investment firms. There are however material differences in the business models and the risks that commodity dealer investment firms pose compared to financial firms. Given the prevalence of the UK as a home for global commodities firms, we believe the opportunity should be taken to adequately reflect these differences in the future UK Investment Firms Prudential Regime (IFPR) for commodity dealer investment firms.

We are concerned that the IFD/IFR regime does not adequately address the position of commodity dealer investment firms which operate within an industrial (non-financial) group. Such firms exist first and foremost in order to aggregate and manage group commodity price risk arising from industrial activity, in much the same way as treasury divisions do for group financial risk.

Such firms do not pose a systemic risk to the financial system. Counterparty credit risk stemming from such firms' trading operations will only arise if this activity is large enough so as to potentially trigger the default of a commodity firm with the consequence that financial institution counterparties of this firm themselves default. This is unlikely for a host of reasons, including:

(a) the share of speculative commodity derivatives trading (as opposed to hedging activity) in a large commodity group's balance sheet is relatively small, and such firms' exposure to financial institutions is mainly based on their physical assets; and
(b) credit risk management requirements under the European Market Infrastructure Regulation (EMIR) mean that exposures will either be cleared or subject to uncleared margining requirements.

Therefore default risk stemming from commodity firms' trading activities is extremely unlikely to cause systemic risk in the financial markets.

The core activity of most commodity firms or groups is the supply and transport of energy, agricultural commodities or metals, and the management of production facilities. Due consideration should be given to the fact that physical assets (oil fields, refineries, ships, real estate) are an essential part of the core business of commodity dealer investment firms and mitigate the risks of their derivative transactions. While these firms do vary their hedge ratio through trading, as long as the net trading position is smaller than the physical position or their asset holding a risk reduction effect is achieved.

In view of the above, CMCE Members ask the FCA to consider including an optional exemption for such commodity dealer investment firms (i.e. those from groups whose main business is not banking or investment banking activity) from the scope of the future UK IFPR.

Where such a firm is concerned to take advantage of an EU third country access right on the basis of a possible future EU equivalence decision under the Markets in Financial Instruments Regulation (MiFIR), that firm would need to be subject to a UK IFPR which is "equivalent". Where, however, such a firm wishes to focus its trading activities primarily in the UK markets, taking advantage of the UK's position as a global centre for commodity derivatives trading, there would be no reason to apply the disproportionate prudential requirements under the IFR/IFD regime within the UK IFPR to them. We therefore request FCA to consider an optional exemption for such firms.

Specific comments on the DP

Transitional provisions

The IFR transitional relief under Article 57(3) appears to be drafted to address (a) investment firms which were previously subject to the Capital Requirements Regulation (CRR) and (b) investment firms which did not previously exist. It is not expressed to address investment firms which were *exempt* from CRR, like commodity firms under Art 493 CRR, but which were previously in existence.

We would ask the FCA to clarify how it intends to apply the transitional provisions for "exempt IFPRU commodity firms" and "exempt BIPRU commodity firms" which did not have own fund requirements under CRR. This is a clear gap in the IFR transitional regime, which we would request the FCA to address in the design of the future UK IFPR by clarifying that such firms can benefit from the transitional relief for capital requirements.

We also note that the specialist commodity dealer exemptions under article 493 and 498 of CRR are due to expire on 31 December 2020. We understand the European Commission intends to extend the application of these exemptions, but if, by chance the Commission does not succeed in legislating to do so by the end of the Brexit Implementation Period, it is imperative that the UK incorporates an extension into the onshored version of the CRR. Otherwise commodity dealer investment firms would be required to switch from Ch 3 of IPRU/Inv to a CRR model, incurring significant development and IT costs in the process, for what will likely be a 6 month period before the IFPR enters into force.

Exemption from concentration risk requirements for Commodity & Emission Allowance Dealers

Article 42 of EU IFR exempts Commodity & Emission Allowance Dealers from the concentration risk requirements under the condition (among other things) that the counterparty is a "non-financial counterparty" ("NFC").

CMCE Members are concerned that the reference to "NFC" would geographically limit the application of the exemption to exposures of commodity dealer investment firms to UK NFCs.

If it is assumed that "non-financial counterparty" refers to the definition under Art. 2(9) of EMIR, this would limit the exclusion in the EU IFR to undertakings established in the EU. Under the retained EU law version of EMIR ('UK EMIR'), however, the definition of "non-financial counterparty" is limited to firms established *in the UK*.

If the IFPR took the same approach, the concentration risk exemption would be capable of applying only where a firm deals with a UK NFC. This would defeat the purpose of the exemption, which is designed to provide commodity firms with the ability to centralise group commodity price risk from group companies in other jurisdictions without triggering concentration risk limits.

CMCE Members, therefore, ask the FCA to implement this exemption with a modification to this condition so that it would be available where a commodity and emission allowance dealer (among other things) deals with a UK NFC, or a non-UK firm which would be an NFC if it were established in the UK.

Proportionality in the application of remuneration requirements

CMCE Members would welcome an FCA approach to proportionality under the future UK regime for prudential requirements for investment firms based on a careful assessment of what is most appropriate for the UK market, as opposed to having equivalence with the EU IFR/IFD based regime as the starting point. We would support the creation of a new proportionality rule by the FCA on the basis of the current rule under CRR/CRDIV.

We would be very pleased to further discuss any of the above issues and to provide any clarifications you may need.

Sincerely,

Samina Anwar
Chair
CMCE Executive Committee