

Information Circular

Markets in Financial Instruments Directive II (“MIFID II”)¹

Commodities firms - amendments to the ancillary exemption

You may find this circular helpful if you are a:

- (i) non-financial entity incorporated or established in a European Union (“EU”) Member State; and
- (ii) engaged in the trading of commodity derivatives, either on EU exchanges or on an over-the-counter (“OTC”) basis.

NO ADVICE

Whilst we hope that you find this circular useful, please note that it is for information purposes only and does not constitute legal advice. Accordingly, you are referred to the disclaimer at the end of this circular.

(i) Current position

Persons:

- dealing in own account in financial instruments; or
- providing investment services in commodity derivatives or derivative contracts to the clients of their main business, provided this is an ancillary activity to their main business, when considered on a group basis, and that business is not the provision of investment services as defined in Markets in Financial Instrument Directive I (“MiFID I”)² are exempt from needing to apply for authorisation from their National Competent Authority.

(ii) Position from 3rd January 2018

MIFID II will narrow the scope of exemptions that are available to non-financial firms which trade in commodities derivatives as an ancillary activity. From 3rd January 2018, in order for *speculative trading activities* in commodities derivatives to be considered ancillary to a firm’s main business (which must not be MIFID investment business) they must fall below two thresholds. In summary, these are:

¹ Directive 2014/65/EU.

² Article 2(i) Directive 2004/39/EC.

(i) *The trading activity test / market share test*

This compares the size of a firm's trading activity³ against the overall trading activity in the EU in any of eight commodity asset classes (see appendix one to this letter for details of each overall market threshold). The overall commodity trading activity is calculated by aggregating the gross notional value of EU venue contracts and all OTC contracts entered into by a firm located in the EU for each asset class to which a firm is a party.

Please note that hedging transactions, plus some other types of transactions are not taken into account for the purposes of performing this test (see appendix two to this letter a list of excluded transactions).

(ii) *The main business test*

This compares the size of speculative trading activity in commodities derivatives against the size of the main activity undertaken by the group of entities of which a firm is a member. This second test provides two methods for calculation, firms may choose either method:

- a. commodity trading activity of the firm vs commodity trading activity of the group⁴. Under this method, if a firm's speculative trading activity is:
 - 10-50% of the total trading activity of its group, it will be considered an ancillary activity providing that the firm's market share is less than 50% of each threshold (see (i) above, e.g. 2% for metals);
 - equal to or greater than 50% of the total trading activity of its group, it will be considered an ancillary activity providing that the firm's market share is less than 20% of each threshold (see (i) above, e.g. 0.8% for metals); **OR**
- b. estimated capital employed for carrying out commodity trading activity based on the sum of total assets of the firm's group minus its short-term debt (less than 12 months maturity) as recorded in the consolidated financial statements of the group. The estimated capital employed is the sum of the following:
 - 15% of each net position, long or short x price for the commodity derivative;
 - 3% of the gross position, long plus short, x price for the commodity derivative;

³ This is a simple average of the daily trading activities during **three** annual calculation periods that precede the date of the calculation, e.g. the first calculation for 2018 will take into account the years 1st January – 31st December 2015, 2016 and 2017. However, a firm only need take the most recent calculation period if its daily trading activities decline by more than 10% when comparing the most recent calculation period to the earliest of the three preceding calculation periods and daily trading activities in the most recent of the three calculation periods is lower than the two preceding calculation periods.

⁴ The total size of the trading activity of the group is calculated by aggregating the gross notional value of all contracts in commodity derivatives, emission allowances and derivatives thereof to which persons in that group are party to.

during three annual calculation periods⁵ that precede the data of calculation.

Please note that hedging transactions, plus some other types of transactions are not taken into account for the purposes of performing these tests (see appendix two to this letter a list of excluded transactions).

(iii) What happens if a firm exceeds either of these thresholds?

Firms that exceed either threshold will be caught by MIFID II and will need to apply for authorisation to conduct regulated MIFID business in their home Member State. Additionally, firms that exceed the threshold will: (i) need to comply with other regulations in full, such as the European Markets Infrastructure Regulation (“EMIR”) and capital requirements under the Capital Requirements Directive (Directive 2013/36/EU and Regulation 575/2013 together known as “CRD IV”); and (ii) will be considered financial counterparties under EMIR.

(iv) Do I need to do anything even if I do not exceed the thresholds outlined above?

Yes. Although firms that do not exceed either threshold will be able to continue to benefit from the ancillary exemption, they must notify their National Competent Authority (“NCA”) (e.g. in the Financial Conduct Authority in the UK) of their intention to rely on the ancillary exemption within the timeframes that have been set out by their NCA.

It is important to note that:

- firms that seek to rely on the ancillary exemption must annually refresh⁶ their notification to their NCA; and
- NCAs may ask firms that seek to rely on the ancillary exemption to explain why they believe that they are able to benefit from it. This may involve requests for evidence that transactions are objectively measure as reducing risks directly relating to commercial activity or treasury financing.

(v) What should I be doing now?

The Commission Delegated Regulation requires that you:

- if you have not already done so, **revise your internal policies** to describe the following:
 - the types of commodity derivative included in the portfolios used to reduce risks directly relating to commercial activity or treasury financing activity and their eligibility criteria;
 - the link between the portfolio and the risks that the portfolio is mitigating;

⁵ The calculation period is 1st January – 31st December each year, e.g. the first calculation for 2018 will take into account the years 1st January – 31st December 2015, 2016 and 2017. However, a firm only need take the most recent calculation period if its estimated capital allocated to speculative trading activities declines by more than 10% when comparing the most recent calculation period to the earliest of the three preceding calculation periods and daily trading activities in the most recent of the three calculation periods is lower than the two preceding calculation periods.

⁶ In the first quarter of each calendar year.

- the measures adopted to ensure that the transactions concerning those contracts serve no other purpose than covering risks directly related to the commercial activity or the treasury financing activity of the non-financial entity, and that any transaction serving a different purpose can be clearly identified; and
- ensure that you are able to provide a **sufficiently disaggregate view** of the portfolios in terms of class of commodity derivative, underlying commodity, time horizon and any other relevant factors.

In addition to the above, we would recommend that you:

- monitor your NCA's website for details of its annual notification requirements (as described in (iv) above);
- monitor the ESMA's website for details of how and when trading activity data will be made available for the various commodity asset classes as described in order to allow you to perform the tests set out in (ii) above; and
- take legal advice if you require any further clarification, or are otherwise unsure about, the contents of this letter.

(vi) Can Sucden Financial help its clients in fulfilling any obligations that they have as a result of the changes that MiFID II is making to the ancillary exemption?

Unfortunately, Sucden Financial is unable to provide legal and/or regulatory advice to its clients because it is not authorised to do so.

Appendix One

Overall market thresholds⁷

Asset class (derivatives trading)	Threshold
Metals	4%
Oil and oil products	3%
Coal	10%
Gas	3%
Power	6%
Agricultural products	4%
Other commodities, including freight	15%
Emissions	20%

Appendix Two

Excluded transactions⁸

- (a) Intra-group transactions as referred to in Article 3 of Regulation (EU) No 648/2012 that serve group-wide liquidity or risk management purposes;
- (b) transactions in derivatives which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity. In order to fall in this category of excluded transaction, a transaction must meet one or more of the following criteria:
 - (i) the transaction reduces the risks arising from the potential change in the value of assets, services, inputs, products, commodities or liabilities that the person or its group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells, or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring in the normal course of its business;
 - (ii) the transaction covers the risks arising from the potential indirect impact on the value of assets, services, inputs, products, commodities or liabilities referred to in point (i), resulting from fluctuation of interest rates, inflation rates, foreign exchange rates or credit risk;
 - (iii) the transaction qualifies as a hedging contract pursuant to International Financial Reporting Standards adopted in accordance with Article 3 of the Regulation on the Application of International Accounting Standards (No 1606/2002).
- (c) transactions in commodity derivatives and emission allowances entered into to fulfil obligations to provide liquidity on a trading venue, where such obligations are required by regulatory authorities in accordance with Union law or with national laws, regulations and

⁷ Article 2(1) of the Commission Delegated Regulation of 1.12.2016.

⁸ Points (a), (b) and (c) of subparagraph 5 of Article 2(4) of MIFID II and Article 5 of Commission Delegated Regulation of 1.12.2016.

administrative provisions, or by trading venues.

Source: Fifth sub-paragraph of Article 2(4) of the Markets in Financial Instruments Directive II (2014/65/EU) (<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065>)

In addition to the above, any transactions that have been entered into by a group entity that is already a regulated entity in accordance with MIFID II or CRD IV can also be excluded for the trading activity test⁹.

Appendix Three

Useful websites

- European Securities and Markets Authority's MIFID II page:
<https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir>
- UK Financial Conduct Authority's MiFID II page:
<https://www.fca.org.uk/markets/mifid-ii>
- French Autorité des Marchés Financiers page re: the regulation of commodities (in French):
<http://www.amf-france.org/Reglementation/Dossiers-thematiques/Marches/Matieres-premieres/La-regulation-des-marches-des-matieres-premieres.html>
- German Bundesanstalt für Finanzdienstleistungsaufsicht page:
https://www.bafin.de/DE/Startseite/startseite_node.html

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⁹ Article 2(2) of the Commission Delegated Regulation of 1.12.2016.