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The law of unintended consequences from current regulatory reform

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Overview

- The current wave of regulatory reform
- Hedging issues
- Capital Requirements – reduced liquidity
- Transparency, confidence and volatility
- Overregulation? Harmonisation?
- Where do we go from here?

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The current wave of regulatory reform

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Overcoming the challenges of hedging

Where is hedging relevant in this suite of regulation?

EMIR

Non-Financial Counterparties: are you subject to the clearing obligation?

MiFIR

Ancillary activities exemption

Commodity position limits

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EMIR – the clearing obligation threshold for NFCs

Asset class	Threshold (gross notional)
OTC interest rate derivatives	EUR 3bn
OTC credit derivatives	EUR 1bn
OTC equity derivatives	EUR 1bn
OTC FX derivatives	EUR 3bn
OTC commodities and anything else	EUR 3bn

If you breach ***any*** of the above thresholds, you are potentially in-scope for clearing ***all*** of the above.

Positions have to be calculated on a ***group*** basis.

But… you can exclude OTC derivative contracts that are "objectively measurable as reducing risks directly relating to ***commercial activity*** or ***treasury financing activity*** of your entity or of your group.

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EMIR – the clearing obligation threshold for NFCs

- **Calculated on a gross notional basis**, without taking into account any collateral that you have received to offset the exposure

- Calculation **includes intra-group trades**

- As a result, it **captures NFCs that are not systemically important**

- Group covers your global group, so your EU entity may be an NFC+ as a result of the activities of your non-EU affiliates: **creates issues for corporates with a parent outside the EU** and incentivises third country entities to avoid dealing with EU counterparties (because they want to avoid being required to comply with EMIR)

- **Portfolio hedging** is very challenging: if a single trade in the portfolio is speculative, you can't rely on the hedging exemption. It matters, because by deeming those positions to all being speculative (rather than a hedge), you increase the chance of losing the ancillary activities exemption under MiFID II… and being **brought into scope of CRD IV**

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MiFID II – ancillary activities exemption

Two pronged test:

- Market share test
- Trading activity test

MiFID II – ancillary activities exemption

Market share test

ESMA's earlier suggestion was that you'd lose the exemption if you had more than 0.5% of the market in any one of 8 commodity asset classes:

- Metals
- Oils and oil products
- Coal
- Gas
- Power
- Agricultural products
- Other commodities (including freight)
- Emission allowances or derivatives thereof

MiFID II – ancillary activities exemption

Market share test: ESMA's latest RTS has replaced this with a more granular market share test, which has different thresholds by asset class:

Size of the relevant trading activity *at group level* in a *commodity asset class* in the *EU*

Size of the *overall* trading activity in a commodity asset class in the EU

Asset class to which the derivative relates	Threshold
Metals	4%
Oil / Oil Products	3%
Coal	10%
Gas	3%
Power	6%
Agricultural products	4%
Other commodities (including freight)	15%
Emission allowances or derivatives thereof	20%

Drafting error: RTS should make clear that the numerator is only capturing **EU** trades

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MiFID II – ancillary activities exemption

Trading activity test

This test replaced the "capital employed" test previously proposed by ESMA

Size of the relevant trading activity, ***excluding privileged transactions*** and ***transactions executed by authorised entities*** of the group, undertaken by the group in ***all commodity asset classes***

Size of the overall trading activity, excluding privileged transaction and transactions executed by authorised entities of the group, undertaken by the group in ***all MiFID II financial instruments***

The baseline threshold is 10%

%	Able to rely on exemption?
<10%	Yes, if you pass the market share test
10%<, >50%	Only if the trading activity for each commodity asset class is <50% of the market share threshold for that asset class
50%<	Only if the trading activity for each commodity asset class is <20% of the market share threshold for that asset class

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MiFID II – ancillary activities exemption

What are privileged transactions?

- **Intra-group transactions** per EMIR Article 3 (but need your affiliate to be in a jurisdiction deemed equivalent under EMIR…)

- **Hedges relating to commercial activity of treasury financing activity** (but they've incorporated the EMIR Q&A answer to Question 10 here, so you have the challenge of stripping out what is hedging versus what is speculative…)

- Transactions in **commodity derivatives** and **emission allowances** entered into **to fulfil obligations to provide liquidity on a trading venue**, where required by law or the rules of the trading venue (but where such obligations apply because you are algo trading or market making under Article 17(3), you can't rely on this exemption…)

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MiFID II – ancillary activities exemption

- "Gross notional value" **not defined** for the purposes of the market share test

- Tests must be determined by reference to an EUR-denominated gross notional value, so you have to consider the **fx rate** that you are using

- You need to **notify your NCA *annually*** to inform them that you are using the exemption

- A firm breaching one of the two tests can no longer use the exemption: there are **no transitional provisions**, so in theory you are committing a **criminal offence** if you trade a commodity derivative whilst waiting for your authorisation as an investment firm to come through (which will take months…)

If you can't rely on this exemption nor any others, you are caught by MiFID II/R
(so have to obtain authorisation to become an investment firm)
and are thereby subject to CRD IV
(which will add a huge cost to your business…)

MiFID II – commodity position limits

- ESMA previously proposed a limit of 25% for each contract, which could be adjusted +/- 15% by the relevant NCA, and the limit was based on deliverable supply for all months

- ESMA now proposes:
  - a limit of 25% for each contract, which can be adjusted +10% or -20% (positions must be aggregated, unless you are a collective investment scheme)
  - deliverable supply only used for the spot month (open interest used for all others)
  - New regime for new/illiquid contracts (2,500 lots whilst the open interest in the contract is <10,000 lots over a consecutive 3 month period)

- You can only net your ETD hedge against your OTC for the purposes of the position limit regime if the two contracts (ignore post-trade terms) are ***identical*** – so, you can net an LME warrant traded OTC against one traded on exchange, but ***proxy hedges*** (e.g. OTC Bauxite vs ETD aluminium) *cannot be netted*.

- NFC- can apply for an exemption from position limits with respect to hedges that directly relate to your commercial activities (but, in contrast to the EMIR position with respect to the clearing obligation threshold, your treasury financing activity is NOT capable of exemption). However, you have to **apply to your NCA in advance** and **on a trade-by-trade basis** for the exemption. And it **takes up to 21** days to obtain the exemption from your NCA…

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MiFID II – commodity position limits

For the purposes of the position limit calculations, you cannot net:

- your physical commodity holdings against your commodity derivative positions
- your MiFID II commodity derivatives against your non-MiFID II positions

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CRD IV / Capital Requirements Regulation

- If you are required to register as an investment firm under MiFID II, you will also become subject (eventually) to CRD IV and CRR
- The requirements for own capital and large exposure rules are currently scheduled to apply from 2018, but the European Commission is considering whether to push back the application date to 2020
- Some commodity trading firms are already subject to capital requirements, but many more will be caught, e.g. smaller commodity prop traders may now become caught, as may the energy companies with trading arms that engage in significant amounts of speculative trading. Intention is to "level the playing field" between banks and non-banks engaged in speculation on commodities via commodity derivatives
- This may restrict the way you can do business, or require a restructuring
- Risk of migration of affected firms outside of the EU and/or a reduction of liquidity in EU
- CRD IV also imposes remuneration restrictions on certain senior personnel

CRD IV / Capital Requirements Regulation

- CRD IV / CRR also applies to banks acting as clearing brokers under EMIR (e.g. with respect to LME Clear, ICE Clear Europe and CME Clearing Europe): the leverage ratio in CRR introduces a balance sheet cap on leverage, the effect of which is to create a finite balance sheet capacity for banks to clear derivatives contracts for their clients

- Is there enough balance sheet capacity amongst the clearing broker community to enable all firms with a mandatory clearing obligation under EMIR to clear?

- Leverage ratio is not risk-sensitive (it is calculated on gross notional of the derivative contract and does not take into account any margin received with respect to the derivative contract): FIA Europe and its affiliates are actively lobbying for the leverage ratio to be amended to recognise the exposure-reducing effect of segregated margin.

Greater Transparency, increased confidence and lower volatility?

Greater transparency?

- EMIR trade reporting
- MiFID II transaction reporting
- MiFID II commodity position limit reporting
- MiFID II pre- and post-trade transparency requirements
- MAR reporting
- REMIT reporting
- SFTR reporting

Increased confidence?

- margining of cleared and OTC derivatives under EMIR
- post-default porting under EMIR
- more visibility on transactions

Lower volatility? The commodity markets are rather volatile currently…

Over-regulation? Harmonisation?

Over-regulation? Arguably not, just inconsistent regulation, which is also being implemented at differing speeds around the world:

- CRD IV conflicts with access to clearing under EMIR
- CRD IV application to non-bank commodity derivative players conflicts with the aims of jobs and growth under the Capital Markets Union plans, due to the impact of those costs on the real economy
- CRD IV will likely result in a *significant* drop off in liquidity, which may push spreads wider and make hedging more challenging
- CRD IV, and certain aspects of the wider derivatives regulatory reform package, will result in business leaving Europe
- US implemented its derivatives markets rules much more swiftly but (i) they are much narrower in scope and application and (ii) they have now issued hundreds of no-action letters (a remedy which Europe does not have) to address errors/regulatory over-reach
- We lack a standardised regime in Brussels for recognition of third country laws
- The lack of a standardised insolvency regime results in significant issues with respect to clearing
- There is still widespread disagreement among global legislators and regulators on how to agree *and implement* global standards

Where do we go from here?

Legislators, regulators and politicians are well aware of the above. In many cases, they agree with the challenges/conflicts that we have raised. They want to get it right, just as much as the industry does.

The European Commission's "better regulation" agenda is resulting in *real change* in Brussels – they are much more transparent, willing to talk and willing to make changes where you can demonstrate (using *data*) that some of the decisions of recent years may not have been the right ones.

Legislators/regulators/politicians are *<u>in listening mode</u>*:

- the European Commission's recent "call for evidence", whereby they have asked for *data* to support your assertions that there are conflicts, underlaps and overlaps in regulation, is a very welcome development, as it their recent EMIR Review consultation; and
- ESMA's discussion paper relating to the treatment of client margin under EMIR is also a welcome sign of them and the European Commission being keen to receive direct industry feedback before making some big decisions on third country equivalence assessments

MiFID II/R will require transformative change to your business. It is essential that you get going with implementation. EU CCP Recovery and Resolution proposals are up next!

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