Taking Stock of Commodity Derivatives Regulation in the UK and EU

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In July 2021, HM Treasury published the Wholesale Markets Review consultation (WMR), which included proposals to reform the U.K.'s secondary markets framework. There was broad support for reforms to (a) modify the ancillary activity exemption to authorization by the Financial Conduct Authority (FCA) and to remove the related annual FCA notification; (b) remove position limits to all commodity derivatives and look-a-like over-the-counter (OTC) contracts and instead require trading venues to set the levels of position limits for contracts specified by the FCA; and (c) establish new exemptions from position limits for contracts specified by the FCA, by revoking the current quantitative threshold and reverting to the previous qualitative test.

On December 4, 2023, the FCA published a consultation paper (CP23/27, the consultation) addressing specific reforms to the commodity derivatives regulatory framework. The consultation sought to build upon the reforms set out in the WMR and closed on February 16, 2024.

We examine the key proposals of the consultation below.

Ancillary Activity Exemption

The MiFID II regime (which is relevant to both the EU and the U.K.)[1] provides an exemption from authorization, known as the ancillary activity exemption (AAE), for firms dealing in commodity derivatives, emission allowances or derivatives of those instruments. This is designed for non-financial firms that can benefit from the exemption where they carry out investment services or activities, which are ancillary to their main businesses, provided certain conditions are met.

In the EU, the AAE was amended from its original formulation in MiFID II. It can be relied upon where any one of the following conditions are met:

- The firm can show that its OTC trading in cash-settled commodity derivatives is below a €3 billion net outstanding notional exposure threshold, which is calculated by averaging the aggregated month-end net outstanding notional values of all contracts in (a) commodity derivatives for cash settlement, (b) emission allowances and (c) emission allowance derivatives for cash settlement, for the previous 12 months entered into in the EU by any entity within the firm's group (de-minimis threshold test).
- The firm can show that its speculative trading in commodity derivatives accounts for 50% or less of the trading in commodity derivatives of all other entities in its group (trading test).
- The firm can show that the capital employed in carrying out its speculative trading in commodity derivatives accounts for no more than 50% of the capital required for the business of the group (capital test).

The EU-wide market share criterion was removed from the tests. The EU's changes to its AAE came after the transitional period following Brexit and, as such was not onshored into U.K. law.

[1] Article 2(1)(j), Markets in Financial Instruments Directive 2014 (Directive 2014/65/EU).

In the U.K., as part of preparations for Brexit, a transitional regime was introduced whereby:[2]

- A firm that was undertaking activity covered by the AAE and that had made an application for authorization during a calendar year remained exempt during that period until the application had been determined or withdrawn.
- A firm need not perform the market share test because relevant data was not publicly available from an official source. The FCA stopped publishing the relevant data once the EU stopped using the market share test and the European Securities and Markets Authority stopped publishing data on the overall size of the market for different asset classes in February 2022. The FCA clarified that firms need not undertake the market share test and, when relying on derogations from the main business test, could use historic data for the overall size of the market.

These changes will continue to apply to the current year (2024-2025) following HM Treasury's decision to push back the revocation of the transitional provisions to January 1, 2025.

UK Reform

HM Treasury proposed legislation to introduce three main changes:

- Removal of the requirement for firms using the U.K. AAE to make an annual notification to the FCA.
- Removal of the quantitative tests as set out in MiFID RTS 20.
- Removal of any transitional provisions that are no longer relevant under the new qualitative test.

The new legislation is due to come into effect at the start of 2025.

The consultation proposes the introduction of FCA guidance on the application of the simplified U.K. AAE that covers the following elements:

- Confirmation of the FCA's understanding of "ancillary," *i.e.*, something that is "related" and "subordinate" to the main business of the group.
- Confirmation that firms can have regard to the trading and capital employed thresholds used in the revised EU tests to judge what is ancillary.

It is further proposed that, despite the removal of the annual notification, the FCA may still ask firms to provide information that would help it to understand the basis on which the firm considers that it can rely on the U.K. AAE.

[2] Article 72J of the Regulated Activities Order (RAO).

Position Limits

Under MiFID II, position limits apply to all commodity derivatives traded on trading venues and to OTC contracts that are look-a-likes of those contracts, known as economically equivalent OTC contracts (EEOTC). In the U.K., the FCA was given the power to specify the commodity derivatives to which the position limits apply.[3]

Critical Contracts

The consultation contains a register of "critical contracts" that the FCA proposes should be subject to position limits. Critical contracts are those for which:

- The risk from abusive practices or disorderly trading carries the greatest potential negative impact to relevant markets in a way that threatens the objectives of the regime.
- Position limits and the accompanying position management contracts are effective arrangements to mitigate those risks.

In creating the list of critical contracts, the following criteria are proposed to be included in the *FCA Handbook*. Not all components of the criteria need to be met for a derivative to be considered "critical," and the assessment of each criterion is to be considered holistically:

- The settlement method at expiry — physically settled commodity derivatives are more susceptible to the risks of disorderly pricing or settlement of positions than cash-settled contracts.
- The size of the commodity derivative market compared to the underlying physical commodity and the robustness of the reference price used to settle contracts.
- The type of underlying and the impact on end users — particular regard is to be given to agricultural derivatives and whether the derivative contract is a key benchmark for pricing the underlying commodity market.
- The size and liquidity of the market — factors such as the open interest, traded volumes and the number and variety of market participants will be relevant here.

Once the FCA determines that a new contract is a critical contract, it is proposed that it will provide market participants with a 45-day notice period, during which the FCA will consider any comments on its assessment of a contract as "critical." The new contract will be added to the register as of the effective date included in the initial notice. Trading venues will have to establish position limits, in line with the proposed framework

[3] The Financial Services and Markets Act 2023 (FSMA 2023) revoked the requirement that position limits must be applied to all commodity derivatives traded on a trading venue and to EEOTC contracts.

considered below, within the later of (a) 30 days of a published decision to add a contract to the list, or (b) within a day of the critical contract being added to the FCA register. Market participants will be expected to comply with the position limits set from the relevant effective date.

Related Contracts and Method of Application of Position Limits

Under the proposed regime, trading venues will be required to publish the list of related contracts for each critical contract traded on their markets. The consultation proposes that related contracts should include, as a minimum, options on critical and related contracts, mini, balance-of-the- month (Balmo) and mini-Balmo contracts, inter-contract spreads that include a critical contract and cash-settled look-a-like contracts that are linked to the critical contract in accordance with the following criteria:

- Any commodity derivative traded on a U.K. trading venue, the settlement price of which is directly or indirectly linked to the settlement price of a critical contract.
- Any commodity derivative traded on a U.K. trading venue that can result in a position or delivery obligation in the critical contract or another of its related contracts, either via an exercise, settlement or expiration.

It is proposed that position limits should apply to the participant's net positions in the critical contract and all related contracts, consistent with the FCA's current approach.

Setting Position Limits

Under the current regime, the FCA is responsible for setting the position limits for all derivatives in scope of the regime in accordance with the methodology set out in MiFID RTS 21, which differentiates between "spot months" (the month in which a contract becomes deliverable) and other months.

The proposals will shift the responsibility to trading venues to calibrate position limits according to features of the market, the underlying commodity and the prevailing market conditions, using a criteria-based approach. While many of the criteria considered in MiFID RTS 21 will remain relevant, the proposals include some changes — trading venues will also be expected to apply different position limits to both spot months and other months, and should consider whether multiple position limits should be set within the spot month period and/or the other months' period, respectively, where not doing so may risk undermining the protections provided by the regulatory regime and create a risk of arbitrage.

The new proposed criteria that trading venues should consider are:

- Deliverable supply in the underlying commodity — generally, the lower the deliverable supply the lower the position limit should be.
- Aggregate open interest and its relationship with the deliverable supply — generally, the larger the open interest as a proportion of deliverable supply, the lower the position limit should be.
- Maturity — trading venues shall establish different position limits for spot and other months.
- Volatility in relevant markets and ability to risk manage — generally, the higher the volatility, the lower the position limits should be.
- Liquidity in relevant markets.
- The ability to make or take delivery and characteristics of the underlying commodity market.

Exemptions From Position Limits

Under MiFID II, the only exemption from position limits relates to hedging activity by non-financial firms. Non-financial firms can apply to be exempt from position limits when hedging against risks arising from their commercial activities (hedging exemption). However, two new exemptions are proposed for (a) financial firms providing risk-mitigation services to non-financial firms hedging their commercial risk (pass-through hedging exemption), and (b) liquidity providers (liquidity provider exemption).

Under the proposals, trading venues will be responsible for the granting and the ongoing monitoring of exemptions. Firms that intend to rely on an exemption must apply to the trading venue and provide the information required by each type of exemption under the trading venue's rules, which should specify the time needed to make a decision and to respond. The proposals also require trading venues to consider establishing a limit on the size of a participant's exempt positions (exemption ceiling) and to mitigate the risk of such positions becoming so large that they undermine the protections provided by the regime.

It is proposed that trading venues should only grant the existing hedging exemption where they satisfy themselves that the exempt positions can reasonably be managed, including the ability of the position to be unwound in an orderly way during times of market stress where market liquidity may be constrained. The non-financial firm should therefore provide the trading venue with information about the relevant commodity derivative positions it holds, including related OTC derivatives.

Trading venues will be able to grant the pass-through hedging exemption when:

- The financial firm enters into an OTC position with a non-financial firm that is conducting hedging activity, and the financial firm offsets the OTC position by entering into an in-scope commodity derivative contract.
- The financial firm enters into an in-scope commodity derivative contract with a non-financial firm where the non-financial firm is using the hedging exemption.

The liquidity provider exemption can be granted provided that:

- The position arises as part of the firm's obligation as a liquidity provider.
- The obligations to provide liquidity is clearly defined by the trading venue and relates to observable metrics of market quality.
- The position should not be held for longer than necessary to discharge those obligations as a liquidity provider and should be reduced as soon as reasonable possible, and in any case sufficiently before the expiry of the contract.

Position Management Controls and Reporting

Position Management Controls

The current position management controls regime, as specified under Article 57 of MiFID II and Market Abuse Regulation (MAR), requires a trading venue to operate position management controls, which includes having the power, at a minimum, to:

- Monitor open interest positions.
- Access information, including all relevant documentation, from persons about the size and purpose of a position or exposure, any beneficial or underlying owners, any concert arrangements and any related assets or liabilities in the underlying market.
- Require a person to terminate or reduce a position, including taking appropriate action if the person does not comply.
- Require, where appropriate, a person to provide liquidity back into the market at an agreed price and volume on a temporary basis with the express intent of mitigating the effects of a large or dominant position.

Trading venues already operate a variety of arrangements as part of their position management controls. The proposals expand on this, by introducing accountability thresholds that apply for all critical contracts and their related contracts. Similar to position limits, trading venues will be required to establish different accountability thresholds for spot months and other months.

A trading venue's methodology for setting accountability thresholds should have regard to the objectives of the regime and, at a minimum, consider the following criteria:

- The relevant position limit, the factors determining that precise limit and the need to ensure positions can be investigated before risks crystallize.
- Whether the volume and any required remedial action of accountability threshold breaches indicates that the control is being effective in providing early warning of position limit breaches and enabling action.
- Periods of market concentration in trading activity.

Once an accountability threshold has been exceeded, trading venues should consider the following factors as part of their investigation:

- Historic and anticipated position sizes and risk management capability at market participant level.
- The extent and quality of the participant's engagement with the trading venue and response to inquiries.
- Where a contract is physically deliverable, the complexity of the delivery process relative to that participant's expertise in deliveries for that deliverable commodity contract.
- An assessment relative to the rest of the market, including comparable peers.

Trading venues will be expected to review their accountability thresholds at least annually when there is a significant change to the relevant position limit or when there is a change that significantly impacts the above criteria. They will also be required to develop and maintain a risk assessment framework that underpins oversight/surveillance arrangements and to notify the FCA for agreement in advance of implementing its methodology and setting the levels of accountability thresholds, and of subsequent material changes to either.

Position Reporting

Under the current regime, there are two types of reporting requirements in relation to positions in commodity derivatives:

- Public weekly reports providing information about the aggregate positions held by different categories of firms for each commodity derivative, including EEOTC contracts.
- Daily reports, provided to the FCA only, with positions held by each person, including by the members or participants of a trading venue.

The consultation proposes to introduce an obligation for trading venues to receive from their members and their clients, up to and including the end client, additional reporting when certain conditions are met, using a risk-based approach. The following minimum set of conditions will trigger additional reporting to the trading venue:

- When a participant's aggregated exempt position is equal to or larger than the relevant exemption ceiling for specified commodity derivatives contracts set by the trading venue.
- When a participant's aggregated position, including exempt positions, in critical and related contracts is equal to or larger than the relevant accountability threshold.
- Additional situations that are determined by the trading venue in its risk assessment framework.

Where additional reporting is triggered, the reporting should continue for a period specified by the trading venue that is appropriate to the risks posed by the position in the market or as long as the person's position is above the relevant exemption ceiling or accountability threshold. The additional reporting that a participant will be required to report should encompass both position reporting in related OTC derivative contracts and position reporting in related contracts traded on non-U.K. trading venues. The trading venue may also require the following additional information, and should determine whether such is necessary to assess the risks related to the large position and where it might source the data from:

- Forward trades in the relevant underlying commodity.
- Trades that are used to settle a futures contract.
- Inventories, storage and infrastructure integrity at the locations where deliveries into the relevant contract are made, including the ownership, control and concentration of delivery locations.

We shall continue to monitor U.K. and EU developments in the commodity derivatives regulatory space and will provide further updates as appropriate.