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28 October 2016

MiFID Coordination
Markets Policy and International Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Via Email: cp16-19@fca.org.uk

Dear Sirs

GFMA CWG Response to the Financial Conduct Authority Consultation on Markets in Financial Instruments Directive II Implementation (CP16/19)

The Global Financial Markets Association¹ (GFMA) Commodities Working Group (CWG) welcomes the opportunity to comment on the Financial Conduct Authority (FCA) Consultation on the Markets in Financial Instruments Directive II Implementation and includes below its response to the question related to commodity derivatives (Chapter 2 – Question 2).

Summary

In respect of the FCA's proposed new MAR chapter, MAR 10, GFMA CWG broadly welcomes the FCA's proposals however believes that certain points within MAR 10 require further clarification.

With respect to position limits, we request that the FCA clarifies:

- whether a firm is required to ensure that positions it holds are within the relevant limit on a continuous basis, or to ensure that positions it holds are within the relevant limit on an end-of-day basis;
- what steps a firm should take in order to address any positions held that exceed the relevant limit and to notify the FCA of a limit being exceeded; and

¹ The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit www.gfma.org.

- the circumstances in which a non-EEA entity might become subject to UK position limits. We would welcome confirmation in MAR that the position limits regime in MAR does not apply to two persons in a country (or countries) outside the EEA, who have no link to the UK, trading OTC contracts that are economically equivalent to contracts traded on UK trading venues.

With respect to position reporting, we request that the FCA:

- clarifies that any reference to "client" is to the term as defined in the FCA Handbook (and in MiFID II) and that the term "end client" should be read in light of this definition of "client";
- explores the possibility that reporting under MAR 10 is permitted on a T+2 basis; and
- confirms that, where MAR 10.4 provides for duplicative reporting, firms are permitted to comply with their reporting obligation by delegating that obligation to a regulated market, a UK firm operating an MTF or OTF, or a UK branch of third country investment firm operating an MTF or OTF.

In addition, we request that the FCA consider the issues (as set out in section 7 below) of the proposed definition of "commodity derivative" in the Glossary. If such issues are not to be considered in formulating the definition of "commodity derivatives", we request the definition be aligned with the definition of that term in MiFIR.

Chapter 2 – Commodity derivatives

Question 2: Do you agree with our proposed new MAR chapter, MAR 10? If not, how would you suggest we modify our proposals?

We welcome the FCA's proposed new MAR chapter, however we note that in some instances MAR 10 would benefit from further clarity. In this respect, we note the following:

1) Position limits – timing of the position limits obligation: We would welcome clarification regarding timing for holding a net position within the established limits.

MAR 10.1.1G(2)(a) states that Article 57(1) and 57(6) MiFID II require "competent authorities or central competent authorities to establish limits, on the basis of a methodology determined by ESMA, on the size of a net position which a person can hold, together with those held on that person's behalf at an aggregate group level, at all times, in commodity derivatives traded on trading venues and economically equivalent OTC contracts to those commodity derivatives". However, MAR 10.2.2D(1) states only that "a person must comply with commodity derivative position limits established by the FCA". It does not expressly indicate the timeframe within which a person must comply.

Therefore, we would suggest an amendment to MAR 10 to clarify whether a firm is required to comply with position limits by ensuring the positions it holds are within the relevant limit on a continuous basis, or whether it is required to comply by ensuring the positions it holds are within the relevant limit on an end-of-day basis (or on some other basis).

Further, if a firm is required to comply with position limits by ensuring the positions it holds are within the relevant limit on a continuous basis, MAR 10 should clarify how a firm may meet this requirement, for example,

in respect of inadvertent breaches and intraday breaches of position limits. Such breaches of position limits may arise due to events outside the control of a firm to which a position limit applies, for example, due to market movements or a change in the position limit set by a competent authority. It will be important for firms to understand whether they might be considered to be in breach of the position limits

regime where an inadvertent breach occurs as a result of factors outside the control of the firm, and whether they would be expected to notify the FCA of this breach under MAR 10.5.4 – 10.5.6, and whether they may be subject to penalties for breach.

2) Position limits – territorial scope of the position limits regime: We would welcome clarification regarding the territorial scope of the position limits regime, in particular regarding the circumstances in which a non-EEA entity might become subject to UK position limits. The FCA states at page 14 of the Consultation Paper that "the Treasury, in its CP, explained its view on the territorial scope of position limits. It said where two persons in a country outside the EEA, with no link to the UK, trade OTC contracts that are economically equivalent to contracts traded on UK trading venues position limits do not apply".

However, we note that the draft rules set out in MAR 10 appear to be inconsistent with the FCA's interpretation of the Treasury Consultation Paper. In particular MAR 10.2.2D(4) states that "position limits ... shall apply regardless of the location of the person at the time of entering into the position", and MAR 10.1.2G(1) states that "in respect of position limits requirements in MAR 10.2, a commodity derivative position limit established by the FCA applies regardless of the location of the person at the time of entering into the position and the location of execution". Additionally, we note that MAR 10.5.7 states that "the powers of the FCA referred to in MAR 10.5.1G to MAR 10.5.3G can be applied to a person regardless of whether the person is situated or operating in the UK or abroad, where the relevant position relates to a commodity derivative or emission allowance of which the FCA is the competent authority or central competent authority, or economically equivalent OTC contracts".

We would therefore welcome confirmation in MAR that the position limits regime does not apply to persons in countries outside the EEA, who have no link to the UK, trading OTC contracts that are economically equivalent to contracts traded on UK trading venues.

3) Position limits – application of decreasing position limits: MAR 10.2.1G(3) states that "[RTS 21] provides that the FCA can establish different position limits for different times within the spot month period of a commodity derivative, and those position limits shall decrease towards the maturity of the commodity derivative, and shall take into account the position management controls of trading venues". We would encourage the application of decreasing limits in circumstances where decreasing limits are deemed appropriate having regard to the nature of the underlying commodity. Furthermore, we would welcome guidance on how the FCA proposes to calculate and communicate decreasing limits to firms, in particular so as to allow firms to make any required internal system changes in a timely manner to ensure that positions held by the firm are correctly monitored against the revised decreasing limits.

4) Position reporting – reporting of client positions: The requirement under Article 58(2) MiFID II for a firm trading outside of a trading venue to report a complete breakdown of its positions as well as those of its clients and the clients of those clients until the end client is reached raises significant technical and legal concerns for firms.

MAR 10.4.8D and 10.4.9D implement this requirement into the FCA Handbook, and require firms to provide the FCA with a report containing a complete breakdown of:

- (a) their positions taken in those *commodity derivatives* or *emission allowances* traded on a *trading venue*;
- (b) economically equivalent *OTC* contracts; and
- (c) the positions of their *clients* and the clients of those clients until the end client is reached.

Similar requirements are set out in MAR 10.4.3R(4) in relation to firms operating an MTF or OTF, and in MAR 10.4.7D in relation to members or participants of regulated markets or MTFs and clients of OTFs.

In each provision, the first reference to "client" is to the term as defined in the FCA Handbook (and in MiFID II). However, subsequent references to "client" are not defined. It appears that the FCA intends these subsequent references to "client" to have a meaning other than that given in the FCA Handbook and in MiFID II. However, we note that MiFID II does not distinguish between the different references to "client".

We therefore propose that MAR 10.4 be amended to make clear that each reference to "client" is a reference to the term "client" as defined in the FCA Handbook and that the term "end client" should be read in light of this definition of "client". We understand that these amendments would mean that:

- (a) only "a *person* to whom a *firm* provides, intends to provide or has provided a service in the course of carrying on a *regulated activity*, or in the case of *MiFID* or *equivalent third country business*, an *ancillary service*" is a "client" for the purposes of MAR 10.4; and
- (b) where a "client" (Client A) does not itself have a "client" for the purposes of the FCA Handbook, Client A will be the "end client".

However, one particular issue, client confidentiality, poses a significant roadblock to end client reporting. We note that there are practical difficulties associated with attempting to obtain information required under MAR 10.4 in respect of clients. For example, there may be jurisdictions in which release of the information is illegal regardless of client consent. Moreover, clients' client agreements may contain explicit confidentiality provisions prohibiting the "upstream" flow of position information. These difficulties are likely to make it practically impossible for an individual firm to identify the complete chain of clients "until the end client is reached".

We therefore propose that an entity should only be required to request position details from its clients where the request and provision of those position details would not breach any laws protecting the confidentiality of the client. In the event that disclosure of this information would breach such laws, the entity should be permitted to withhold or redact the identity of the client if such steps would prevent the breach from occurring.

We strongly believe that this approach is the only workable solution to avoid the reporting obligation putting firms in a situation where they simply cannot be compliant with the requirements of MAR 10.4 without breaching a number of legislative principles (many of them being criminal offences) such as data protection, blocking status and bank secrecy.

5) Position reporting – timing of reports: MAR 10.4.8D(3) and MAR 10.4.9D(3), implementing Article 58(2) MiFID II, require UK MiFID investment firms and UK branches of third country investment firms to submit their reports to the relevant competent authority by GMT 17:00 the following business day, i.e., on T+1. MAR 10.4.7D, implementing Article 58(3) of MiFID II, is silent on timing although presumably members, participants or clients of trading venues will be required to submit their reports in a manner which allows the operators of trading venues to meet their own reporting obligations. In this regard, MAR 10.4.5D(2)(b)(ii)

requires UK firms operating an MTF or OTF and third country investment firms operating an MTF or OTF to submit their daily reports to the FCA by GMT 17:00 the following business day. We note that draft paragraph 7BB of the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 as inserted by the draft Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2016, referred to in MAR 10.4.2G, does not specify the time by which regulated markets must submit their daily reports to the FCA.

Reporting positions prior to the completion of back office procedures may result in reporting errors which would need to be corrected once these processes have been completed. On T+1 firms may still be reconciling, editing and rerunning positions and T+2 would therefore allow sufficient time to report accurately. In this regard, we note that the CFTC requires T+2 reporting for OTC positions.

We believe that, for consistency, the provisions in MAR 10.4 should have identical reporting deadlines and, in light of the issues surrounding the reporting of OTC positions, we believe that T+2 is an appropriate reporting deadline. We would be happy to discuss this in more detail with the FCA.

6) Position reporting – potential for duplicative reporting: Our understanding is that MAR 10.4.8D and MAR 10.4.9D, implementing Article 58(2) MiFID II, require UK MiFID investment firms and UK branches of third country investment firms to provide the FCA with a report containing, inter alia, a complete breakdown of their positions (i.e. on-venue and OTC positions) in commodity derivatives or emission allowances traded on a trading venue. We believe this would result in duplicative reporting as the FCA would already be provided with the on-venue positions pursuant to MAR 10.4.3R(3), implementing Article 58(1) MiFID II.

In respect of potential duplicative reporting, we propose that the FCA permits UK investment firms and UK branches of third country investment firms to comply with the obligation to report on-venue positions under MAR 10.4.8D and MAR 10.4.9D by delegating the reporting obligation to the regulated market, UK firm operating an MTF or OTF, or third country investment firm operating an MTF or OTF with the same reporting obligation. In addition, we propose that the FCA permits delegation of reporting obligations to a third party capable of making such reports, such as another investment firm, as permitted under other European legislation such as EMIR.

7) Definition of "commodity derivatives": Annex A of the Consultation Paper sets out the following proposed definition of "commodity derivative":

commodity derivative – those *financial instruments* defined in point 44(c) of article 4(1) *MiFID*; which relate to:

- i. a *commodity*; or
- ii. an underlying referred to in Section C(10) of Annex I to *MiFID*; or in points (5), (6), (7) and (10) of Section C of Annex I to *MiFID*.

We assume that this definition is intended to be consistent with that contained in Article 2(1)(30) of MiFIR. However, before addressing that issue, we would note that the definition in Article 2(1)(30):

- (a) includes securitised commodity derivatives in contradiction to the principle that transferable securities (Section C(1)) are not derivatives (Sections C(4) – C(10)) and therefore are not subject to the same

legal regime as derivatives. We believe that transferable securities, such as securitised commodity derivatives, should not be subject to the position limits regime.²

- (b) includes all derivatives contracts on underlyings referred to in Section C(10), i.e. climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash, as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in Section C of Annex I MiFID II. Consequently, position limits appear to apply to non-commodity contracts in Section C(10). We believe that, of the financial instruments falling within Section C(10) of Annex I MiFID II, the only contracts which should be subject to position limits are those contracts which relate to an underlying commodity which itself may be subject to a supply constraint (e.g. freight). Other contracts that do not relate to commodities (i.e. inflation, statistics, assets, rights, obligations and indices that are not related to commodities) should not be subject to the position limits regime.³

We would encourage the FCA to consider these definitional issues further and we would be happy to discuss them in more detail.

If the above issues are not to be considered in formulating the definition of “commodity derivatives” and that definition is to be along the lines contained in Annex A of the Consultation Paper, we would take this opportunity to note that the definition is not aligned with the that of "commodity derivatives" in Article 2(1)(30) MiFIR, which states:

'commodity derivatives' means those financial instruments defined in point 44(c) of Article 4(1) of [MiFID II]; which relate to a commodity or an underlying referred to in Section C(10) of Annex I to [MiFID II]; or in points (5), (6), (7) and (10) of Section C of Annex I thereto.

In particular, the draft definition in the Consultation Paper requires all commodity derivatives to be financial instruments as defined in Article 4(1)(44)(c) of MiFID II, i.e., transferable securities. Accordingly, we would suggest the following reformulation of the proposed definition in alignment with Article 2(1)(30) MiFIR: commodity derivatives – those *financial instruments* defined in:

- i. point 44(c) of Article 4(1) *MiFID* which relate to a *commodity* or an underlying referred to in Section C(10) of Annex I to *MiFID*; or
- ii. points (5), (6), (7) and (10) of Section C of Annex I to *MiFID*.

The Commodities Working Group welcomes the opportunity to provide these comments on the

² Please see the Joint Association paper on "MiFID II Commodity derivatives position limits – Application to securities commodity derivatives", available at <http://www.gfma.org/Initiatives/Commodities/GFMA-ISDA-FIA-LEBA-and-EFET-MiFID-II-Commodity-Derivatives-Position-Limits-Paper/>.

³ Please see the Joint Association paper on "MiFID II Commodity derivatives position limits – Application to non-commodity contracts in Annex I Section C.10", available at <http://www.gfma.org/Initiatives/Commodities/GFMA-ISDA-FIA-LEBA-and-EFET-MiFID-II-Application-of-Position-Limits-to-Non-Commodity-Contracts-and-to-Securitized-Commodity-Derivatives/>.

Consultation Paper and looks forward to having an ongoing dialogue with the FCA.

Yours truly

A handwritten signature in black ink, appearing to read "David Strongin". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

David Strongin
Executive Director
GFMA