

GFMA CWG response to the HMT Wholesale Markets Review

About GFMA Commodities Working Group

The Commodities Working Group of GFMA focuses on regulatory issues specific to banks operating in the financial and physical commodities markets. The CWG's work centres around the promotion of a level regulatory playing field for the commodity markets, advocating consistency and avoiding duplication among legislative measures.

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 <http://www.gfma.org>.

Chapter 6: Commodity Markets

65 Do you think that the scope of the 'commodity derivatives' regime should be narrowed to derivatives that are based on physical commodities?

We understand that where HMT refers to the "commodity derivatives regime", this is a reference to the position limit, position management and reporting regime for commodity derivatives (i.e., the provisions of Title IV to MiFID II)¹ rather than a reference to the definition of "commodity derivatives" under MiFID II / the Regulated Activities Order, which has a broader application.

In that context, GFMA and its members are supportive of narrowing the scope of this regime to exclude instruments which do not relate to physical commodities.

In particular, GFMA has previously advocated² narrowing the scope of the position limit, position management and position reporting regimes to exclude derivative contracts within Section C(10) of Annex I to MiFID³, which currently fall within the definition of "commodity derivatives" but which do not have a physical commodity underlying. GFMA's previous advocacy sets out the classes of C(10) instruments that should not be subject to the position limit, position management or position reporting regimes, those being options, futures, swaps, forward rate agreements and other derivative contracts relation to inflation derivatives; an index or measure based on actuarial statistics; and other derivative contracts that do not exhibit the profile of, or a direct relationship to, a commodity. If HM

¹ As implemented in the UK through Part 3 of the FSMA 2000 (Markets in Financial Instruments) Regulations 2017/701, UK RTS 21 and the relevant sections of the FCA Handbook

² <https://www.gfma.org/wp-content/uploads/0/83/91/219/a2c047ee-3fd8-48c4-8d46-21da4ec138e4.pdf>

³ As set out in Parts 1 and 2 of Schedule 2 to the Regulated Activities Order 2001



Treasury's proposal is to ensure that all such C(10) instruments would fall outside the position limit, position management and position reporting regimes, GFMA would welcome this.

However, as mentioned above, we would urge HM Treasury to be specific regarding what it considers to be the "commodity derivatives regime". In particular, the definition of "commodity derivative" is not only used to define the scope of the position limit, position management and position reporting regimes, but is used more broadly across other pieces of legislation and guidance (including in the ancillary activities exemption). If HM Treasury intends to amend the definition of "commodity derivative", rather than the scope of the position limit, position management and position reporting regimes, we would welcome an industry-wide consultation to assess the potential consequential impacts of such a change and to avoid any unintended consequences.

66 Do you think that financial instruments which refer to commodities as a pricing element but are securities in their legal form, should be removed from the regime?

Yes, GFMA and its members strongly support removing these instruments from the position limit, position management and position reporting regimes.

This approach would align with the approach taken in the EU MiFID Quick Fix legislation, and would also help to resolve a discrepancy created by including these instruments within the commodity derivative position limit, position management and position reporting regimes. Instruments which are securities in their legal form are fundamentally different from derivatives, which are bilateral contracts in their legal form. An instrument which is a security in its legal form is treated as a security for the purposes of MiFID and other legislation applicable to securities (e.g., the prospectus regime). An instrument which is a derivative in its legal form are not treated as securities, and are subject to separate regulatory treatment. It is not possible for an instrument to be both a security and a derivative, and including securities within a regime that is designed for derivatives leads to inappropriate outcomes for those securities as well as a blurring of the lines between two fundamentally incompatible regimes (i.e., the securities regulatory regime and the derivatives regulatory regime).

In addition, since there is no possibility of physical settlement of securitised commodity derivatives, they are not capable of having the same impact on physical commodity markets as derivatives falling within Sections C(5), (6) and (7).

67 Do you think economically equivalent OTC commodity derivative contracts should be removed from the commodity derivatives regime?

Yes, GFMA would support the removal of "economically equivalent OTC commodity derivative contracts" (EEOTC) from the position limit, position management and position reporting regime. We consider that this would provide much-needed legal certainty regarding the scope of the regime and would also help to remove a barrier to trading for non-UK firms who currently struggle with the lack of certainty in this area and the potential for extraterritorial application of this regime.



So far as we are aware, no EOTC contracts have been identified to date, and it is not clear what contracts the European Commission had in mind when setting the scope of EOTC. As a result, removing these contracts from the scope of the regime would not result in any material difference in application of the regime, while providing significant legal certainty for market participants.

In addition, the potential scope of EOTC contracts has been a persistent source of concern for non-EU, non-UK firms seeking to trade in commodity derivatives with EU / UK counterparties, as the lack of certainty regarding the definition has meant that they cannot be certain that they are fully in compliance with the regime. Removing the uncertainty around the scope of EOTC contracts would remove a barrier to trading commodities in the UK.

A further source of concern is the fact that commodity derivatives traded on non-UK venues could potentially qualify as EOTC contracts, creating the potential for restrictions on the ability of UK firms to participate on these venues and compete with other international market participants.

One further argument for removing EOTC contracts from the regime is that although we are not aware of any EOTC contracts that have been identified to date, such contracts may come within the scope of the regime in future, with potentially unintended consequences. For example, derivatives on EU emission allowances may come within the scope of the regime in future (or derivatives on UK emission allowances that are traded outside of UK trading venues), adding further complexity to the emerging UK emissions market which would be unwelcome for market participants and would risk blurring the line between emission allowances and commodities as an asset class.

However, we note that HM Treasury's proposal would permit trading venues to "take account" of relevant OTC contracts when monitoring markets. It is unclear what this means and how this would operate in practice. The ability of a venue to "take account" of OTC contracts should be clarified and restricted to what is necessary to maintain orderly markets on the relevant venue. In particular, venues should not be expected to "take account" of OTC trading that takes place outside of the UK or where the only connection between the relevant OTC trading and contracts on the trading venue is that they share a common commodity underlying.

We have seen examples in practice of trading venues understanding similar provisions as requiring them to impose onerous reporting obligations on market participants regarding their off-exchange activities (and in some cases regarding the off-exchange activities of affiliates and unaffiliated clients). Such requirements lead to significant difficulties for market participants who may be subject to confidentiality obligations or who may not have the ability to obtain this information from affiliates (particularly in corporate structures where affiliates are not under common management or do not have in place structures to aggregate and share this sort of information) or clients.

68 Are there any other instruments that you think should be deleted from the commodity derivatives regime?

Aside from the removal of securitised derivatives and derivatives within C(10) that have no physical underlying, as discussed in our responses above, GFMA would also ask HM Treasury to consider simplifying the definition of what constitutes a commodity derivative for the purposes of UK



regulation. We note that the definition in the Regulated Activities Order covers both the legacy UK definition as well as the MiFID definition. This creates a complex definition that requires some analysis to understand.

However, we would note that if HM Treasury intends to amend the relevant definitions in the Regulated Activities Order it should undertake a separate consultation process to assess the potential impacts of any such changes, particularly on the UK's regulatory perimeter and the licensing regime.

69 What would be the risks and benefits of transferring responsibility for position limits from the FCA to trading venues?

GFMA and its members strongly support transferring responsibility for position limits from the FCA to trading venues. Trading venues are best placed to determine how to ensure orderly conditions for the trading, settlement and delivery of commodity derivative contracts, and transferring responsibility for imposition of any position limits to trading venues will enable the venues to apply appropriate controls that are proportionate to the risks posed by particular behaviours.

Prior to MiFID II, trading venues were responsible for setting their own position limits, and we consider that this approach worked well. The current system of setting position limits has introduced unnecessary complexity to commodity derivative markets as well as making the UK a less attractive trading location for non-UK, non-EU counterparties.

The primary risk of strict and hard-wired, position limits set by regulators is that this hampers the efficient operation of the market where trading activity, which is neither abusive nor contributing to a disorderly market, might take a participant past one of the limits. GFMA members consider that the current regime has had a dampening effect on the markets for less liquid contracts and hampers the ability of UK venues to develop new contracts. We would therefore urge HM Treasury to seize this opportunity to take an ambitious approach and move beyond the existing MiFID II position limits regime to a more dynamic and flexible position management approach.

70 What specific factors do you think should be addressed in the framework of requirements that UK authorities would provide for trading venues?

GFMA would support the creation of a high-level framework that would provide guidance and a consistent framework for trading venues when setting position limits.

However, we consider that it is important for trading venues to retain discretion on when to apply position limits. The main purpose of moving responsibility for setting position limits from the FCA to trading venues is to ensure a flexible, market-led approach that is appropriate for managing the risks that the trading venues perceive to their market. As a result, any framework should aim to establish consistent parameters for setting limits without hampering this flexibility.

71 Do you think that the scope of contracts that are automatically subject to position limits should be limited? If yes, do you think that it should be limited to contracts that are critical or significant, which includes those that are physically settled, and agricultural?

GFMA considers that no contracts should be automatically subject to position limits set by the FCA. In line with our response to Question 69 above, GFMA considers that trading venues are best placed to determine whether position limits should be applied to contracts traded on that venue, and the level at which such limits should be set, subject to guidelines or a framework established by the FCA to ensure a consistent basis for the approach adopted by individual trading venues (as discussed above in our response to Question 70).

This would mean a return to a position management approach, which served the UK market well prior to MiFID II and which has the benefit of being more dynamic and market-led. We note that holding a large position in a commodity derivative is not automatically indicative of abusive behaviour and so should not be automatically prohibited. Trading venues are best placed to monitor activity that takes place on their platforms and take appropriate action (which may include imposition of position limits or position management) to address abusive behaviour. The FCA's existing oversight of trading venues also enables it to require venues to act if their position management controls are not effective.

72 Do you think that the UK commodity derivatives regime should allow position limits exemptions for liquidity providers?

Yes, GFMA and its members support this proposal and we agree with the comments made by HM Treasury in the Consultation Paper identifying hedging as an important part of risk mitigation. Market-making and liquidity provision by regulated entities such as banks is an important component of this market.

However, we would caution against defining "liquidity providers" too narrowly. We note that HM Treasury proposes to extend this exemption to all liquidity providers, and to align this with the supervisory approach that the FCA announced in December 2020⁴. However, we also note that the FCA did not define liquidity provider (although it provided guidance on the circumstances in which a firm might benefit from relief and how a firm could demonstrate that it is acting as a liquidity provider). As a result, HM Treasury will need to develop an appropriate definition of "liquidity provider" for the purposes of amending the position limits regime.

The approach proposed by the European Commission in the EU MiFID Quick Fix was to provide for an exemption for liquidity providers where a transaction is entered into to fulfil obligations to provide liquidity on a trading venue, where these obligations are required by regulatory authorities in accordance with EU law or national law, regulations and administrative provisions or by trading venues. We consider this approach to be extremely narrow, in particular because liquidity providers typically enter into liquidity provision agreements voluntarily, not because they are required to do so by applicable law or by the relevant trading venue. In addition, a liquidity provider may not have a formal agreement regarding liquidity provision in all cases.

⁴ <https://www.fca.org.uk/publication/documents/supervisory-statement-mifid-end-transition-period.pdf>

We would welcome an exemption that allows market participants to request an exemption from the position limits regime based on an approach similar to that set out by the FCA in its December 2020 statement, noting (as the FCA does in its statement) that the list of supporting evidence is not exhaustive and that firms may still qualify for an exemption if they do not have a formal liquidity provision agreement with the relevant trading venue:

... we would regard a position to be held by a liquidity provider where it arises from transactions executed to fulfil obligations to provide liquidity on a trading venue. To ensure that a position results from genuine liquidity provision, we would expect a firm relying on this statement to be able to evidence the liquidity obligations it is meeting by reference to the rules, agreements or other written provisions of the trading venue. We would regard evidence of a firm participating in a trading venue's liquidity provider incentive scheme as adequate to show that it is acting as a liquidity provider. This is not the only way a firm might show this.

73 Do you think that the UK commodity derivatives regime should introduce a 'pass through' hedging exemption to enable investment firms to support a wider range of hedging practices?

Yes, GFMA and its members agree that the UK position limit regime should introduce a "pass through" hedging exemption and we support HM Treasury's proposal for a regime that would ensure that investment firms can be exempt from the position limits regime when delivering a wider range of risk-mitigation services, allowing regulated firms to facilitate hedging activity for a commercial entity, even in situations where the risk being hedged arises off-exchange or on a different trading venue.

We also note that the regulated entity needing to rely on such an exemption may not be part of the same group as the commercial entity whose activities are being hedged, so it will be important to ensure that this exemption is not limited to intragroup hedging activities only.

74 Do you think any other activities should be exempt from the regime?

GFMA members consider that the hedging exemption should be based on the characteristics of the transaction itself rather than on the legal status of the counterparties. GFMA members have always been of the view that financial firms could benefit from this exemption and that the limitation to non-financial firms under MiFID II was causing liquidity issues, notably in the less developed markets where only a few market makers are offering hedging tools to end-users.

75 Are there areas of the UK's position reporting regime which could be improved?

GFMA and its members are comfortable with the functioning of the position reporting regime in its current form.



76 Do you think that the ancillary activities test (AAT) should revert to a qualitative assessment of the activities performed by a market participant?

No response

77 Do you think that the basis of the AAT should be expected activity, rather than historic activity?

No response

78 Do you agree that the annual notification requirement should be abolished?

No response

79 Does the continued existence of the separate Oil Market Participant (OMP) and Energy Market Participant (EMP) regimes for commodity derivative market participants serve any meaningful purpose?

No response

80 Do you think that the OMP and EMP regimes should be removed as particular regulatory statuses from the UK's regulatory perimeter?

No response

81 Do you think any changes would need to be made to the MiFID II regime, if the OMP and EMP regimes are removed as particular regulatory statuses?

No response