Adjustment of ESMA's approach towards the ancillary activity exemption (13 July 2015)

ESMA proposes a test combining the **market size test** with a **trading activity test**:

- The trading activity test exclusively takes into account the commodity derivatives transactions concluded in the EU.
- This test compares the sum of the non-privileged/speculative commodity derivatives transactions in the EU (numerator) with the overall sum of all commodity derivatives transactions (denominator) in the group at a European level. There are three threshold categories of the trading activity test (< 10%; 10% - 49.9%; ≥ 50%). The underlying measurement for all of the transactions is gross notional value (GNV).
- Depending on the outcome of this trading activity test, firms are allocated to three different categories of market size thresholds.

For example a firm which stays below 10% of the trading activity test would be allowed to have a market share of 20% in emission allowances. Firms have to assess themselves against these thresholds in 2016, and in case of a breach of the thresholds they will have to apply for a MiFID II license by 3rd January 2017.

Trading Activity Test		***Decreasing Factor***	***Market Size Test***				
Non-privileged commodity derivatives transactions / Overall sum of commodity derivatives transactions (in GNV)			***Gas, Oil***	**Power**	***Coal***	***Freight & others***	***Emissions (EUA)***
Threshold Category 1	< 10%	*1*	3%	6%	10%	15%	20%
Threshold Category 2	10% - 49.9%	*0.5*	1.5%	3%	5%	7.5%	10%
Threshold Category 3	≥ 50%	*0.2*	0.6%	1.2%	2%	3%	4%

<u>This approach should be adjusted as follows:</u>

1. **Introduction of a stepwise test to determine if commodity trading activity is ancillary to the main commercial business (“trading activity test”)**: Our proposal is that non-financial firms can apply a stepwise trading activity test to assess whether their commodity trading activity is an ancillary activity to their main business on a group basis: A non-financial firm which exceeds a threshold of one of the categories of the trading activity test as proposed by ESMA (e.g., it exceeds the trading activity threshold given in the threshold category 1), can apply in a second step the capital employed test. Depending on the outcome of this second test, it can make use of the same market size thresholds of this threshold category (e.g., 10% coal). Please see the summary of our proposal on page 4 of this paper. In detail:

   - <u>1st trading activity test</u>: At first firms have to apply the trading activity test as proposed by ESMA to show that their non-privileged commodity derivatives transactions are ancillary to their main group commercial business. This test compares the sum of the non-privileged/speculative commodity derivatives transactions in the EU with the overall sum of all commodity derivatives transactions in the group at a European level. Depending on the result of this test, they will be allocated to one of the three categories of market size thresholds: Firms will remain exempted when the sum of their non-privileged commodity derivatives transactions stays below the market size thresholds for each commodity asset class. For example a firm which stays below the threshold category 1 of the trading activity test would be allowed to have a market share of up to 10% in coal derivatives. This approach would keep the additional administrative burden as small as possible for firms, such industrial firms, for which it is not common practice to allocate capital for certain activities (like trading or hedging activities or intra-group transactions).

   - <u>2nd trading activity test</u>: Non-financial firms which exceed the threshold category in this first trading activity test, should then have the chance to take into account their main commercial business on a group basis, as this will better align the trading activity test to the MIFID II Level 1 text. These firms can use as a second trading activity test the capital employed test, which was originally proposed by ESMA in its consultation from December 2014. This test compares the capital employed for non-privileged commodity derivatives transactions in EU against the capital employed for total global main group business. The main group business means the non-investment/non-banking business of a global group, e.g., production, transport, distribution and supply, and includes the privileged commodity derivatives transactions (intragroup, hedging and liquidity provision transactions).
     Depending on the result of this capital employed test, non-financial firms will again be allocated to one of the three categories of market size thresholds: Firms will remain exempted when the sum of their non-privileged commodity derivatives transactions stays below the market size thresholds for each commodity asset class. For example, a non-financial firm which exceeds the threshold category 1 for the trading activity test as proposed by ESMA, can apply in a second step the capital employed test and if it passes this second trading activity test it can make use of the same market size thresholds of this threshold category 1 (e.g., 10% coal). For those non-financial firms, which are commonly allocating capital to their activities, the capital employed test is a better proxy, because it would enable these firms to represent correctly the size of their main corporate business without establishing processes overly burdensome to them. In addition, this stepwise approach takes into account that many firms, especially those stemming from the commodity sector, prefer the capital employed test originally proposed by ESMA. Finally, the capital employed test would be also in line with MiFID II which states that “ESMA may determine that the capital employed for carrying out the ancillary activity relative to the capital employed for carrying out the main business is to be considered.”

   Overall, this stepwise test is consistent with the MiFID II text because it takes into account of the overall main commercial business of a group (see wording Recital 20, Art. 2 (1) (j) and Art. 2 (4) of MIFID II). The industry would be happy to contribute to a clear definition of “capital employed” to enable a harmonized implementation.

2. **20% lower boundary for trading activity test**: A 10% lower boundary is arbitrarily low and is likely to capture many small/medium-sized firms for whom a halving of allowed market share before

regulation is likely to lead to their departure from the market or at least considerable reduction of their activity. This reduced liquidity impact would be significant for the EU economy (see next point no. 3). The reason is that the allowed market size within the threshold category 2 is significantly lower than in the threshold category 1 due to the decreasing factor of 0.5 and it is likely that many small and medium sized firms will breach these lower thresholds.

3. **Create one asset class for gas and power and increase the market size threshold to avoid significantly reducing liquidity**: We propose to create one asset class for gas and power because gas and power products are very interdependent and highly correlated. A cautious joint market share threshold of at least 12% should be set initially for the joint gas and power asset class. A market size threshold considerably less than 12 % will result in market participants leaving these energy markets or at least considerably reducing their activity to avoid prohibitive compliance as well as prudential capital and liquidity regulatory requirements. A vicious circle would ensue where lower wholesale market liquidity results in significantly higher trading costs, which would undermine competition and increase market entry barriers, as potential entrants would be deterred by the high costs and/or the inability to hedge. This would, in turn, have a direct effect on energy prices and ultimately, on final energy consumers. The overall impact on the EU economy would be a significant increase in energy prices at the expense of competitiveness and economic growth. Any reduction of market liquidity would be detrimental to the viability and sustainability of European energy markets and the real economy. A higher threshold is also justified from the regulatory perspective as gas and power markets are both subject to the same REMIT rules and therefore transparent and orderly supervised.

4. **Increasing the EUA market size threshold to avoid an EUAs compliance trap**: It was not the legislative intent for emission allowances (EUA) traded for compliance reasons under the EU ETS to fully count towards the thresholds, cf. exemption of Art. 2(1)(e) of MiFID II. ESMA's proposals mean that corporates would find themselves caught in an EU ETS compliance trap, i.e. they will be exposed to MiFID II licensing requirements, if EUAs traded for compliance are not considered privileged transactions. Consequently, EUAs held for regulatory purposes should be acknowledged as privileged transactions. At least, the market size threshold should be set at 20% for all threshold categories.

5. **Extension of threshold calculation period to make implementation possible**: For the following reasons, we propose that the trading activity and market size tests can only be calculated by firms on an average rolling basis of 3 years, starting at the earliest in 2016. First, the MiFID II transactional data concerning market size will only be available at the beginning of the year 2017. Second, the data quality of trade repositories is not yet at a level which makes the transactional data suitable for a reliable and final judgement as to whether a company needs to apply for a MiFID II license. It will be therefore impossible for market participants to apply the thresholds tests <u>and</u> to evaluate whether they will be covered by MiFID II or are able to make use of an exemption before MiFID II applies on 3rd January 2017. In addition, it is not in line with the Level 1 text of MiFID II that the calculations are to be conducted based only on data collected during 2016 under MiFID I, especially because the definition of commodity derivatives differs substantially between MiFID I and MiFID II. Therefore, both from a legal and practical point of view, the earliest calculations on the ancillary activity thresholds can be conducted at a point in time when firms' accounts are audited and reliable transactional data are validated. It is important that ESMA sets the threshold for each asset class based on robust and reliable data.

6. **Review by ESMA:** In our opinion ESMA retains the possibility to propose changes to the Regulatory Technical Standards (including the thresholds) at any time (subject to according mandate from the EU Commission and the specified legislatory process) which allows scope for taking into account changes in market size or structure. This flexibility means that there is no need for a formal re-opener in Level 1 or 2 and allows an appropriate balance to be struck between introduction of the new MIFID II regime for commodities and protecting market liquidity.

Summary of our proposal (changes highlighted in blue)

Trading Activity Test			*Decreasing Factor*	*Market Size Test*				
First Test		*Second Test*						
Non-privileged commodity derivatives transactions in EU / Overall sum of commodity derivatives transactions in EU (in GNV)		**Capital employed for non-privileged commodity derivatives transactions in EU / Capital employed for total global main group business**		***Oil***	**Gas and Power**	***Coal***	***Freight & others***	***Emissions (EUA)***
Threshold Category 1	< 20%	< 20%	*1*	3%	12%	10%	15%	20%
Threshold Category 2	20% - 49.9%	20% - 49.9%	*0.5*	1.5%	6%	5%	7.5%	20%
Threshold Category 3	≥ 50%	≥ 50%: not applicable	*0.2*	0.6%	2,4%	2%	3%	20%

These tests can only be calculated by firms on an average rolling basis of 3 years, starting at the earliest in 2016. With regard to the threshold category 3 it has to be mentioned, that non-financial firms have only to apply the first trading activity test, because a capital employed share of above 49.9% would not “constitute a minority of activities at a group level” according to the Level 1 text of Mi