

MiFID II: what it means for Gafta members

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Directive 2014/65/EU on markets in financial instruments (MiFID II) applies on 3 January 2018. This legislation makes significant changes to the regulatory framework applicable to agriculture commodity derivative markets in Europe, including new rules for Gafta members that may use derivative contracts to manage risk. These changes are summarised briefly below.

Restricted exemption

MiFID II materially restricts exemptions to authorisation that may be used by Gafta members that deal on own account in agricultural commodity derivatives or provide investment services in these financial instruments to third parties. The new Article 2(1)(j) MiFID II (the “ancillary activity exemption”) provides an exemption from the general authorisation requirement for persons who deal on own account in commodity derivatives, emission allowances and derivatives thereof, or provide investment services in these financial instruments to customers or suppliers of its main business, subject to two cumulative conditions. These are:

1. that the relevant activity constitutes “a minority of activities at a group level” and,
2. that the relevant activity accounts for a small proportion of “overall market trading activity in that asset class”.

These conditions are further specified in Commission Delegated Regulation 2017/592, which prescribes a two-part test that persons need to “pass” in order to use the exemption - a market share test and a main business test.

For the purpose of the tests a person needs to take into account all transactions in exchange traded derivatives (ETDs) executed on a trading venue located in the European Union (EU) and all over-the-counter (OTC) contracts to which that person is party. Recent Q&A guidance from the European Securities and Markets Authority (ESMA) confirms that, for the purpose of relevant threshold calculations, EU persons wishing to use the ancillary activity exemption are not required to take into account derivatives transactions executed on third country markets and platforms. This may significantly simplify use of the exemption for many Gafta members. However, ESMA also confirmed that OTC derivatives transactions executed by non-EU persons of an EU group with an EU person must be considered as taking place in the EU and as such must be included for the purpose of the market share test.

Persons meeting the conditions of the exemption must notify their national competent authority accordingly. Exempt persons must also notify the same competent authority each year thereafter that they continue to meet the conditions of the exemption.

MiFID II does not include transitional provisions for persons that engage in regulated activities. Certain national competent authorities have attempted to introduce national level transitional periods. However, this is not common practice across the EU28, and when MiFID II applies on 3 January any EU person transacting in agricultural commodity derivatives should be either duly authorised to do so or exempt from authorisation per Article 2(1)(j) MiFID II.

Gafta members should also not overlook their dealing in foreign exchange (FX) derivatives, which may be undertaken by their treasury department to hedge currency risk. Article 2(1)(d) MiFID II provides for an exemption for persons dealing on own account in derivatives other than commodity derivatives, emission allowances or derivatives thereof, and as such includes dealings in FX derivatives. There are, however, new exclusions to this exemption that may apply to Gafta members using popular trading venues for transactions in FX derivatives.

Position limits and position reporting

Article 57 of MiFID II **mandates that national introduces** limits on the size of net positions which persons may hold in commodity derivatives traded on EU-based trading venues and so-called “economically equivalent OTC contracts” (EEOCs). The new position limits regime is expansive in scope and applies to all persons with positions in commodity derivative contracts in scope, regardless of their establishment, domicile or regulatory status.

Relevant for Gafta members, the *Autorité des Marchés Financiers* (AMF) in France and the UK Financial Conduct Authority (FCA) have both published position limits for various agriculture commodity derivative contracts offered by Euronext Paris and ICE Futures Europe. These include Euronext’s Corn and Milling Wheat No 2 contracts and ICE’s UK Feed Wheat Futures. The good news for Gafta members is that these bespoke limits for both spot month and all other months are quite generous. Details of the position limits can be found on the websites of the AMF, the FCA, Euronext and ICE.

Persons that are “non-financial entities” per the Article 2(1) definition in Commission Delegated Regulation 2017/591 are eligible for and may apply to a national competent authority for a hedging exemption to a position limit. Such persons must be able to demonstrate that they may hold positions in commodity derivatives in excess of a position limit that are “objectively measurable as reducing risk directly related to the commercial activity of that non-financial entity”.

Article 58 MiFID II requires trading venues to gather information on positions in commodity derivatives, emission allowances and derivatives thereof and to report this information daily to their competent authority. Trading venues are also required to make public weekly “commitments of traders” reports with a breakdown of overall positions in relevant contracts by category of trader. Members of trading venues offering clearing services are obliged to aid trading venues in gathering information on positions from underlying clients, and can be expected to seek information on positions held by Gafta members and the purpose of these positions.

MiFID II will bring about significant change to how commodity derivative markets in the EU are operated and increase regulatory oversight of these markets. For Gafta members ensuring compliance with the new rules is expensive and time-consuming, but it is crucial to get it done right and get it done on time.