European Association representing the trade in cereals, rice, feedstuffs, oilseeds, olive oil, oils and fats and agrosupply
Comité du commerce des céréales, aliments du bétail, oléagineux, huile d'olive, huiles et graisses et agrofournitures

Brussels, 10 December 2015

COCERAL position paper on the ESMA Regulatory Technical Standard (RTS) 20, 21 and 2

The members of COCERAL have remaining concerns in relation to **RTS 20** on criteria for establishing when an activity is ancillary to the main business and possible consequences on other tools that are commonly used by agricultural operators, such as the exchange for physicals in **RTS 2.** We would also like to present a major flaw in **RTS 21** on position limits.

We respectfully ask the EU decision makers to consider the following amendments and clarifications to RTS 20, 21 and 2 to avoid major repercussions on the EU agricultural supply chain:

Regulatory Technical Standard 20

Article 3 – Main business threshold

There are serious problems with the approach proposed to assess the main business. The approach assumes that the volume of hedging transactions in derivatives entered into by a firm can be used as a proxy for the main business activity. However there are very wide variations in the extent to which commodity derivatives are and can be used to mitigate risk in commercial business. In many businesses there is just no correlation between the commercial risks and available liquid derivative contracts and so there may be no use of derivatives at all.

In other businesses there is good correlation however the commercial objective is to offset risks to the greatest extent possible in the physical supply channel before considering using derivatives. Derivatives are only used to manage residual risks. A business with large long term sales contracts will seek to lock in as much of its raw material inputs on long term contracts as possible. A firm which may have a relatively small trading business alongside such activities will be inappropriately characterised as a trading business. **A main business test has to allow for the option to use capital or assets as a more correct way to assess relative size.**

We also draw the attention to the definition of the denominator for this second test. The current text spells out that the denominator includes all contracts in "financial instruments". This would include FX, fixed income bonds, equities and all derivatives including those in a financial entity. This can be in no way a proxy to a business' main commercial activity and goes against rules established elsewhere in MiFID.

We support an assessment of a company's main business based on accounting capital as it was initially proposed by ESMA. The capital employed by a firm is a reliable account of the real size of the main commercial business for commodity operators. Whilst recognizing that some firms may have difficulty in apportioning accounting capital, we continue to call for the option to use this methodology where firms are able to do so.

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Proposed wording, RTS 20, Article 3 (proposed amendments underlined)

Main business threshold

1. Ancillary activities shall be considered to constitute a minority of activities at group level compared to the main business of the group where either:

(a) the size of the trading activities calculated in accordance with paragraph 4 does not account for more than 10% of the total size of the trading activity of the group calculated in accordance with paragraph ***5;*** *or*

(b) the capital employed in the trading activity undertaken calculated in accordance with paragraph 6 does not account for more than 10% of the capital employed in the main business at group level calculated in accordance with paragraph 6.

2. By way of derogation from paragraph 1(a),

(a) where the size of the trading activities calculated in accordance with paragraph 4 accounts for more than 10% but less than 50% of the total size of the trading activity of the group calculated in accordance with paragraph 5, ancillary activities shall be considered to constitute a minority of activities at group level only where the size of the trading activity for each of the asset classes referred to in Article 2(1) accounts for less than 50% of the threshold established by Article 2(1) of the overall market's size in the relevant asset class.

(b) where the size of the trading activity calculated in accordance with paragraph 4 accounts for equal to or more than 50% of the size of the trading activity of the group calculated in accordance with paragraph 5, ancillary activities shall be considered to constitute a minority of activities at group level only where the size of the trading activity for each of the asset classes referred to in Article 2(1) accounts for less than 20% of the threshold established by Article 2(1) of the overall market's size in the relevant asset class.

3. By way of derogation from paragraph 1(b),

(a) where the capital employed in the trading activity calculated in accordance with paragraph 6 accounts for more than 10% but less than 50% of the capital employed in the main business at group level calculated in accordance with paragraph 6, ancillary activities shall be considered to constitute a minority of activities at group level only where the size of the trading activity for each of the asset classes referred to in Article 2(1) accounts for less than 50% of the threshold established by Article 2(1) of the overall market's size in the relevant asset class.

(b) where the capital employed in the trading activity calculated in accordance with paragraph 6 accounts for more than 50% of the capital employed in the main business at group level calculated in accordance with paragraph 6 the trading activities shall not be considered to be ancillary to the main business at a group level.

4. The size of the activities referred to in points (i) and (ii) of Article 2(1)(j) of Directive 2014/65/EU undertaken by persons within a group shall be calculated by aggregating the trading activity undertaken by those persons in all of the asset classes referred to in Article 2(1) in accordance with the same calculation criteria as that referred to in Article 2(2).

5. The total size of the trading activity undertaken by persons within a group shall be calculated by aggregating the gross notional value of all contracts in financial instruments as defined in Annex I, Section C (1) to (11) of Directive 2014/65/EU to which persons within that group are a party to.

6. The capital employed in the trading activities calculated in accordance with paragraph 4 and the capital employed in the main business at group level shall be calculated by aggregating total equity, current and non-current debt and current and non-current provisions as calculated from balance sheets, financial statements or accounting information systems.

7. All gross notional values and capital employed measures shall be denominated in EUR.

8. Persons referred to in points (i) and (ii) of Article 2(1)(j) of Directive 2014/65/EU shall determine the main business threshold either according to paragraph 1 (a) or (b) depending on what methodology is most appropriate to their main business at a group level. Persons shall notify the method of calculation used to the national competent authority in accordance with Article [X].

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Article 2 – Trading activity threshold

The current proposal provides no legal certainty as to the data source for the purpose of calculating the trading activity threshold and is highly confusing in defining the numerator and the denominator of the equation. Clarity around this is essential as different potential sources of data could lead to material differences in assessment of market size leaving firms unable to meaningfully assess their status relative to the thresholds.

The current text defines the overall market trading activity (the denominator) as all contracts not traded on a trading venue by persons located in the EU plus contracts traded on a trading venue located in a member state. However the size of the person's trading activity (the numerator) is defined as all contracts traded and makes no reference to the EU nor to Member States. This represents a very significant inconsistency between the denominator and the numerator and creates serious uncertainty as to the treatment of transactions entered into on third country venues by persons located in the EU. In agricultural markets third country venues are a significant portion of activity carried out by entities in the EU.

We are aware of a range of different views as to what the text is intended to mean including that only EU venue contracts should be used in both the numerator and denominator. With this reading any person located in the EU that trades commodities for speculative purposes only on third country venues would be simply excluded from MiFID, whilst a grain collector that is trying to reduce his/her risks will probably be reporting under MiFID.

It is essential that the RTS contains a clear mention of the data that will be used for assessing the overall market size. **We support the use of trade repository data as the only viable source which would be consistent with the methodology used to determine the numerator in the calculation.** The use of trade repositories is the only way to obtain a global and clear view of derivative activity in the EU, since trade repositories are necessarily used for both OTC and on-exchange derivatives transactions reporting under EMIR.

As the deadline for MiFID implementation is approaching, the lack of consistency and readiness by the authorities is becoming clearer. We believe that the proposal under discussion for delaying the implementation of MiFID and MiFIR is very appropriate to allow sufficient time for operators to adapt to the new regime and have sufficient certainty on the new measures, which are still under development. This period would also provide time to refine trade repositories data for the purpose of calculating the overall market size in Article 2.

Article 4 – Procedure for calculation

With regard to the implementation provisions in Article 4, we consider the use of 2015 data inappropriate. Applying the exemption in this manner would necessarily include activities undertaken prior to any certainty on the exemption or on the data for assessing market size. It would be extremely difficult to identify ex-post, with a "sufficiently disaggregated view", which transactions within a portfolio should be considered as eligible for risk management. The use of 2015 data would qualify the measure as retroactive since the definition to be used for the ancillary activity exemption was not available before 2015.

As highlighted under article 2, we believe that the proposal under discussion for delaying the implementation of MiFID and MiFIR is very appropriate to allow sufficient time for operators to adapt to the new regime and have sufficient certainty on the new measures, which are still under development. **If the implementation of MiFID starts as from January 2018, we would support the use of data from the period July 2016 to June 2017 for the calculation to submit in the first year.**

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Article 5 – Transactions qualifying as reducing risks

We consider that globally Article 5 will serve the purpose of appropriately qualifying hedging positions that form part of a portfolio as reducing risk. In Recital 14 ESMA acknowledged the complexity of risk management systems that are required, particularly for agricultural commodity market operators, and the use of portfolio or macro hedging.

To effectively exclude hedging activity from the exemption calculations, as envisaged by the co-legislators, **we suggest to delete the last sentence of Recital 14** that would exclude from the hedging exemption the necessary components of a portfolio that may not be demonstrated as objectively measurable as reducing risks and which actually denies the reality of the physical business including its risk hedging management.

Regulatory Technical Standard 21

Spot Month Limits

A key element of the RTS is that Spot Month Position limits should be based on a percentage of deliverable supply, with other month limits being based on open interest.

This draws on precedents elsewhere in the world, most notably in the United States, which has long had a regime of spot month limits. The crucial difference between the spot month limits as envisaged in Europe and spot month limits in the US, is that the US spot month limits become effective at or around the point at which a futures contract expires, whereas spot month limits in Europe may apply throughout the period during which a contract is the front month.

The RTS defines 'spot month contract' as 'the commodity derivative contract in relation to a particular underlying commodity whose maturity is next to expire in accordance with the rules set by the trading venue'. So for a futures contract such as the Euronext Milling Wheat Future, one contract will become the 'spot' contract at the point at which the previous contract expires. So the day that the May contract expires, the September contract will become the front month. However, applying a tight spot month limit for an extended period prior to delivery obligations crystallising is unnecessary from an orderly markets perspective and will have the effect of constraining legitimate trading activity.

Article 57(3) of MIFID II, Level 1 provides the following: "ESMA shall take into account experience regarding the position limits of investment firms or market operators operating a trading venue and of other jurisdictions." Paragraphs 14 and 16 of ESMA's Final Report on the MIFID II RTS explain the basis on which ESMA has defined "spot month contract". However, in contrast to other parts of the Final Report which deal with position limits (e.g. paragraphs 25 and 26 concerning threshold levels), paragraphs 14 and 16 contain no evidence to suggest that ESMA has considered the definition of "spot month contract" which is applied in non-EU jurisdictions or by national competent authorities and trading venues within the EU. Had ESMA done so, it would have become aware that the definition it was contemplating was inconsistent with established practice in the United States under the regime overseen by the CFTC; and arrangements operated within the EU by the AMF in France and by regulated markets such as ICE Futures Europe in the UK.

We propose that the current definition of 'spot month contract' in the RTS is revised in order to make clear that spot month limits should apply only as the contract approaches expiry.

Regulatory Technical Standard 2

Exchange for physicals (EFPs)
EFPs allow market participants to organize and execute exchange-traded derivatives transactions which are linked directly to a transaction in the underlying physical market. They are widely used for hedging purposes by participants in derivatives markets, including in agricultural commodity markets. Under an EFP, one party will sell a futures contract and buy the physical commodity and the other party will buy the futures contract and sell the physical commodity.

COCERAL believe that **Article 8.1 of MiFIR does exempt non-financial counterparties using hedging tools from pre-transparency requirements.** We see the Article 8.1 exemption operating in the same way as the exemption for central banks in article 1.6 of MiFIR, and as further confirmed by ESMA in its final report at page 161.

Therefore, we see no impediment to continue utilizing EFPs in agri-commodity markets under MiFID2/MiFIR provided that:

1. EFPs are in all cases defined as hedging. EFPs are transactions that are directly linked to and originate from a physical commodity contract, whereby the two parties wish to achieve an agreed price which is generally different from the prevailing on-venue traded price, due to factors which change from the on-venue contract's terms such as product, quality, period of execution, incoterm etc. EFPs have been traded worldwide, and for decades in all commodity markets, and they have no impact in the price discovery process on the exchanges. For this reason, and because one leg of the EFP is in a non-standardised form, exchange rules allow EFPs to be traded outside the central order book.
2. It is clear that EFPs are transactions undertaken by two non-financial counterparties (NFCs), that may however be placed on the market by a financial counterpart (i.e. a broker transmitting orders to the exchange) acting on behalf of a NFCs. This must not prejudge the fact that the EFPs are used by and for the benefit of NFCs.

EFPs are widely used by all agricultural operators of all sizes and represent the natural access to regulated markets for non-financial entities operating in the agricultural markets and needing to hedge the risks of physical transactions. Utilizing the EFP mechanism enables the parties to fix physical quantities without facing the market price risk (which is reflected via the future part of the transaction), hence reducing the overall risk of a transaction. **It is therefore essential that these operators remain classified as NFCs when assessing the ancillary nature of their activity in financial markets through the tests performed according to RTS 20 rules.**

COCERAL is the European association of trade in cereals, rice, feedstuffs oilseeds, olive oil, oils and fats and agrosupply. It represents the interest of the European collectors, traders, importers, exporters and port silo storekeepers of the above mentioned agricultural products. COCERAL's full members are 26 national associations in 18 countries and 1 European association [Unistock]. With about 2500 companies as part of COCERAL national members, the sector trades agricultural raw materials destined to the supply of the food and feed chains, as well as for technical and energy uses. COCERAL has two associated members in Switzerland and Serbia.

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