FCA CP – REFORMING THE COMMODITY DERIVATIVES REGULATORY FRAMEWORK

16 February 2024

Energy Traders Europe welcome the opportunity to respond to the FCA Consultation Paper (CP) 23/27 (Reforming the commodity derivatives regulatory framework) and the constructive proposal included in the paper*.*

We have set out a detailed response to the CP questions in the sections below, however there are a few key points that we would like to draw to the FCA's attention:

- **Additional reporting** – we are very concerned by the proposal to having to report to trading venues, once accountability thresholds are exceeded, detailed information which could expose firms to the risk of breach of competition law and confidentiality clauses;

- **Exemption ceilings –** the introduction of discretionary exemption ceilings is unnecessary and increase the complexity of the regime for market participants with no real added benefit;

- **Ancillary Activity Exemption** – we generally agree with the content of the proposed guidance, however we note that limited legal certainty is provided to market participants as the actual tests are defined by a reference to EU law, and the regime is included under *guidance* instead of *rules*. Moreover, the exclusion of the de minimis threshold would be detrimental to the type of market participants that rely upon it and provide liquidity in UK commodity markets; and in line with the EU approach, the trading test and capital employed test should refer only to volumes traded on 'UK trading venues' and not on 'EU and UK trading venues' as currently proposed.

<u>Q1: Taking into account the proposals outlined below, do you have any specific comments regarding implementation of the new regime? Please explain your answer.</u>

In relation to the implementation timeframe, we have the following concerns regarding the proposals for the position limits/management regime and the ancillary activity exemption.

- **Position limits and position management.** The Consultation Paper (CP) refers to a transitional period to allow time to make the necessary changes to comply with the regime (with the exception of the Ancillary Activity Exemption – 'AAE') which the FCA proposes to be one year after the relevant instruments are made.

    - We welcome the proposal for a timeframe for implementation, however we note that the suggested time period may not be sufficient in particular for market participants when it comes to the position limits and position management controls: they will have to wait for trading venues to finalise the relevant changes to then commence technical implementation to their systems and processes.

    - We therefore recommend that market participants are granted at least six months from when the trading venues have finalised their rules.

- **Ancillary Activity Exemption.** We appreciate the 1 January 2025 deadline established by the Treasury's Regulated Activities Order (RAO), however we are concerned about the very tight timeframe which is available to market participants. Considering that the final rules will only be available in the second half of 2024, it will be extremely challenging for any firms that cannot rely on the AAE to comply with the relevant additional requirements.

<u>Q2: Do you agree with the approach outlined, including the criteria to assess the criticality of contracts? If not, please explain why.</u>

We agree with the principles of the proposed approach and the application of position limits to a more specific set of contracts, including the relevant set of critical commodity derivatives, and their related contracts, traded on UK trading venues.

However, we note that it is difficult for market participants to clearly assess the impact of the regime, in particular because:

- the criteria to identify critical contracts are broad, we appreciate, to ensure that the FCA can effectively calibrate the scope of the regime to the risks to the relevant markets; and

- the overall regime will become more clearly defined once trading venues have fully defined their rules.

<u>Q3: Do you agree with the approach outlined above with respect to related contracts? If not, please explain why.</u>

<u>Q4: Are there any specific types or classes of contracts that should not be included in the related contract concept? If so, please explain why.</u>

In principle, we agree with the proposal to subject related contracts to trading venues' position limits. However, **we believe that the proposed definition of related contract is very wide and could encompass a large number of contracts**.

We recommend to refine the proposed rules to give sufficient flexibility to the relevant trading venues to define as a related contract only those contracts which have a significant (immediate) impact on critical contracts.

Our recommendation would also allow trading venues to ensure a more appropriate treatment for new and illiquid contracts. Under the proposal, these contracts would be immediately subject to position limits as no exemption to exclude them is available; whereas the relevant trading venue should be allowed to apply position limits only once the contract has developed sufficient liquidity and is then able to survive.

<u>Q5: Do you agree with the proposed approach to update the list of critical contracts? If not, please explain why.</u>

We note that the proposed approach to update the list of critical contracts explicitly defines time periods for the FCA to propose an update and consult (45 days) and trading venues to establish a new limit (30 days); however, it does not mention market participants which will have to implement the new limits and manage any open positions accordingly.

On the one hand, we are concerned that the 30-day period would not be sufficient for:

- a trading venue to develop a methodology, consult on the rules with market participants;
- market participants to ensure that their existing positions and planned strategies comply with the new limits.

On the other hand, we believe that the proposed framework should at least **include a grandfathering provision to protect existing positions** that market participants have entered into before any new limit enters into force. Forcing market participants to unwind open positions, and in particular to do so in a very limited timeframe, is likely to negatively impact markets and create unhelpful volatility.

We therefore propose to extend the 30 days to a minimum of 90 days.

Q6: In notifying us of a particular market that requires closer monitoring, are there any other factors that trading venues should consider? If you think there are, please explain what the additional factors are and why they should be considered.

Q7: Do you agree with the list of critical contracts above? If not, please explain why.

Q8: Should any of the three cash settled contracts mentioned above (Dated Brent Future, Dubai 1st Line Future, Singapore Gasoil (Platts) Future) or the physically settled Permian WTI Future be added to the list of critical contracts? If yes, please explain why.

Q9: Taking account of our proposals on position management and the reporting of additional information, do you consider that the risks arising from positions held OTC are adequately dealt with despite the fact that position limits do not apply to OTC contracts? If not, please explain why.

We have no main objections to the proposed list of critical contracts and agree with the FCA's proposal to not apply position limits to OTC contracts.

We note, however, that WTI is already subject to CFTC position limits and question its inclusion in the list of critical contracts: it will increase the complexity that market participants will have to deal with, with limited benefits to the market.

Q10: Do you agree with the approach and framework outlined above for setting position limits? If not, please explain why.

Q11: Do you agree with the criteria trading venues shall consider when developing their position limit setting methodology and when setting position limits? If not, please explain why.

We have no objections to the approach and framework outlined in the Consultation Paper for setting position limits.

Scope of the framework

To ensure that possible future market developments are sufficiently taken into account by the proposed regulatory framework, we believe that the rules should clarify that **position limits established by a trading venue will only apply to critical and related contracts traded on its venue**.

Furthermore, we note that the framework is broad and gives significant discretion to trading venues, which we expect will be mitigated by the obligation for trading venues to issue a consultation prior to setting or modifying position limits; and by the FCA's close oversight of trading venues. Feedback provided by market participants should be properly considered by providing reasoning for acceptance/rejection by the trading venue of the relevant comments. It would be helpful to also provide a formal right for market participants to refer any significant concerns to the FCA that they may have regarding a proposed trading venue's position limits framework.

Application of limits at group level

In relation to the application of position limits at group level, the legal text is unclear about the definition of 'group' which should be used in this context.

We believe in particular that considering that position limits aim to prevent market abuse, the **focus of the aggregation rules should be on the notion of 'control of the positions'** (i.e. control of trading decisions) **and not of 'control of the entity/subsidiary'** (i.e. ownership).

As the FCA notes in the Consultation Paper, 'where a parent undertaking can control the use of subsidiary positions, the parent undertaking should aggregate positions it holds directly with those held by its subsidiaries' (see CP 3.36), i.e. the positions of the group entities should be aggregated only for those companies where the parent company has the authority to make decisions regarding the buying and selling of positions. Otherwise, shareholders that act as pure investors in same products would be hampered in their own business as well as the companies owned. Hence even a further coordination that might be problematic under other laws would need to be established.

The legal text should reflect the interpretation of 'group' based on 'control' of positions/trading activity and, in line with relevant existing trading venues rules, include the ability to not aggregate positions also for firms other than collective investment undertakings.

Q12: Do you agree with the approach to granting exemptions outlined above? If not, please explain why.

We agree with the proposed principles to grant position limits hedging exemptions.

However, we believe that **the rules should include provisions to ensure an orderly transition from the current regime**, where exemptions are granted by regulators, **to the proposed ones**, where trading venues will be granting them. The proposal should consider currently existing exemptions which have been granted by introducing relevant grandfathering clauses and a timeframe for transition to the new regime: it would avoid possible disruptions to the market and reduce the risk of increasing volatility, as market participants will not have to unreasonably discharge existing positions entered into based on current exemptions.

We believe that the **introduction of possible exemption ceilings is unnecessary and** would not ensure that high regulatory expectations apply to the granting of exemptions, but **on the contrary increase the complexity of the regime for market participants with no real added benefit**.

As highlighted in our responses to Questions 17-19, we believe that trading venues already have the sufficient tools to request the relevant information from market participants who hold significant positions.

Q13: Do you agree with the approach to the hedging exemption outlined above and the information to be provided to evidence use of the exemption? If not, please explain why.

We generally agree with the proposed information that market participants have to provide when applying for hedge exemptions. However, we have the following concerns that we would like to draw to the FCA's attention.

Information to be provided to trading venues

Trading venues are private commercial organisations who do not (and should not) have powers to request detailed information similar to those that regulators have, which extend to market participants' confidential and commercially sensitive information. Hence, too detailed information might also be in conflict with competition law.

We therefore **recommend to delete the reference in MAR 10.2.7 (R) 1 (b)** to the trading venue having to be satisfied that 'a non-financial entity's position, at its estimated highest point in the following year can be unwound, in particular during times of market stress where market liquidity may be constrained, in a way that does not impair orderly markets'; and the related obligation in MAR 10.2.8 (R) (5) which requires a market participant to provide 'information regarding the non-financial entity's ability to unwind its positions at their highest point in the following year, including during times of market stress, in a way that does not impair orderly markets'. Our recommendation is in line with the EU regime (see EU MiFID II RTS 21 Art. 8(2)) where this specific requirement is not included.

We are concerned that the provisions, as currently drafted, are very broad and can be interpreted as giving power to trading venues to request specific information, instead of 'descriptions' and 'explanations' as in the other points MAR 10.2.8(R)(1)-(4), including confidential and commercially sensitive information (such as specific positions in the portfolio held outside the relevant venue).

We believe that trading venues can manage the risks addressed by these two specific provisions via their relevant position management powers.

Impact of granted Hedging Exemption on Accountability Thresholds

In our view, it is unclear whether Accountability Thresholds will be taking into account, for a specific market participant, any granted Hedging Exemption: i.e. similarly to the approach for position limits, the level of the accountability threshold for the relevant market participant in a specific product should be increased to reflect the volume of the granted hedging exemption.

If this is not the case, market participants who benefit from a hedge exemption would likely have to exceed the relevant accountability threshold more frequently.

Instances of disagreement between trading venues and market participants

We believe that it would be helpful for **market participants to have a formal right to escalate instances of disagreement with the trading venue** in relation to any hedge exemption (e.g. instances where the trading venue may not be willing to grant a sufficient hedging exemption to a market participant who believes that sufficient evidence of its needs has been provided).

Q14: Do you agree with the approach to the pass-through hedging exemption outlined above and the information to be provided to evidence use of the exemption? If not, please explain why.

We support the introduction of a pass-through hedging exemption for financial firms.

Q15: Do you agree with the approach to the liquidity provider exemption outlined above and the information to be provided to evidence use of the exemption? If not, please explain why.

We support the introduction of a liquidity provider exemption.

Q16: Do you agree that trading venues should establish accountability thresholds for critical contracts?

Q17: Do you agree with the approach outlined above and the factors that should be considered as part of the trading venues' accountability threshold setting methodology? If not, please explain why.

In principle, we have no objection to the obligation to have relevant accountability thresholds.

However, we have a few concerns that we would like to draw to the FCA's attention:

- as we explain in our responses to Questions 18 and 19, **we are very concerned about the onerous proposed reporting obligations to trading venues** which would be triggered when exceeding the accountability thresholds. In practice, they may lead market participants to treat accountability thresholds as hard limits, thus negatively limiting their trading activity and consequently impacting market liquidity.

- We believe that the **current drafting of MAR 10.3.3A R (1)(c) makes the difference between accountability thresholds and position limits unclear**. The provision appears to give powers to trading venues to ask market participants to take steps to reduce positions which have exceeded the accountability thresholds and are 'excessive **or** unjustified'. In our view market participants should be allowed to hold positions which are 'excessive' (i.e. above the accountability threshold), but have been justified to the trading venue. Otherwise, the consequences of exceeding accountability thresholds would be very similar, if not identical, to those faced when breaching position limits. We therefore propose to amend the wording to read along the lines of 'taking steps to manage ~~**excessive or**~~ unjustified **excessive** positions'.

- In relation to the **factors that trading venues should consider when assessing the need for further action once an accountability threshold has been exceeded, we consider that these should be objective and limit trading venues' discretion**. We therefore recommend the deletion of the following criterium 'the extent and quality of the individual member or participant's engagement with the trading venue operator and response to its inquiries' which has no relevance to establish the nature of a trading activity (see MAR 10.3.3G).

- Overall, we believe that the position limits and position management framework should leave a slightly higher degree of flexibility to trading venues. In particular, trading venues should be allowed to **establish position limits only for the spot month period, at least for the time period very close to expiry (i.e. no obligation to have an accountability threshold for this period)**. We are concerned that the overlap of accountability thresholds and position limits, in particular during the last few days before expiry, is likely to be challenging for market participants. They will be required to provide the relevant information in a very tight timeframe, engage in discussions with the trading venue and would ultimately be uncertain whether they can hold their hedging positions during a very critical trading period like the expiry one. Having only appropriately calibrated hard spot limits for this period could provide more certainty to market participant and less disruption to the market.

Q18: Do you agree with the set of conditions that result in the requirement to provide additional reporting? If not, please explain why.

Q19: Do you agree with the information to be reported once the additional reporting requirement is triggered? If not, please explain why.

Q20: Do you agree with the definitions of related OTC contracts and overseas contracts? If not, please explain why.

Q21: Do you consider that additional reporting requirements should apply at a group level rather than entity level for the reasons highlighted in paragraph 6.33 above? If not, please explain why.

We are very concerned about the level of details that the proposal requires market participants to disclose to trading venues when accountability thresholds are exceeded. We believe that it will be detrimental to the UK's trading venues' international competitiveness, as other regimes - such as the US – do not require this level of reporting to trading venues; and, consequently, to UK markets' liquidity.

Allowing trading venues to require market participants to report information about the broad set of positions listed in MAR 10.3.3E, including positions held on other venues and bilaterally with counterparties, can pose significant risks in relation to:

- **competition law**, as the relevant trading venue will receive information about trading activity carried out on venues operated by its competitors;
- and **confidentiality**, as market participants would be forced to disclose details about positions traded OTC with counterparties in violation of contractual confidentiality clauses.

Trading venues, which we have to stress are private commercial organisations in competition amongst themselves which are not regulators, already have the right to require additional information, in particular when the relevant market participants' position becomes significant: information can relate, for example, to the nature and purpose of positions of the relevant participants.

We are also concerned that if there is no sufficient upfront clarity on the actual rules of any reporting to the specific trading venue, market participants will be likely to face significant operational challenges to comply with the additional reporting. These challenges may be exacerbated by the fact that large hedgers, who **need** to hold significant positions out on the curve, are more likely to exceed the accountability thresholds, especially if these are not amended/increased to take into account the granted hedging exemptions.

Therefore, we strongly recommend the deletion of the additional reporting requirements, in particular the details in MAR 10.3.3 E (R).

Q22: Do you agree with the proposal for trading venues to develop a periodic market risk analysis report? Please explain your answer.

Q23: Do you agree that trading venues are best placed to determine for which contracts CoT reports should be published or do you have views on how the criteria should be amended? Please explain your answer.

Q24: Are there any other changes to the public reporting of aggregated positions that you consider appropriate? If yes, please explain the changes you propose and why they are necessary.

No major concern has been identified in relation to these proposals.

Q25: Do you agree with the proposed guidance on the AAT? If not, please explain why.

We generally agree with the content of the proposed guidance on the meaning of 'ancillary' for the purposes of the commodity exemption, which focuses on the relevant trading activity being 'related' and 'subordinated' to the main business of the group. However, **we believe that having guidance instead of rules provides more limited legal certainty in relation to a key regulatory regime such as the ancillary activity exemption, which is ultimately a licence to operate for the relevant firms**. Moreover, we do not agree with the way the proposal refers to the EU Ancillary Activity Exemption tests introduced as part of the MiFID II 'quick fix' reform. In particular, we believe that:

- **The text defining the EU tests should be included in the FCA Handbook, for example as a new question or in a dedicated Annex**. This approach would give market participants more certainty about the guidance that they can rely upon and, most importantly, limit the exposure of UK market participants to the immediate impact of any changes made by third country/EU regulators: see for example previous amendments in the EU which resulted in ESMA not having to publish the annual market volumes information anymore and market participants being unable to perform the market share test calculations. Our proposed approach is also better aligned with the FCA's objectives regarding international competitiveness and growth;

- **References to the de-minimis threshold test should be maintained**. The test is used by a significant number of firms, in particular smaller and medium sized firms as well as firms with a more limited physical asset base, who are active in commodity markets and support their liquidity. The reason for introducing the de-minimis threshold test in MiFID was to both ensure that the available tests 'take account of the economic reality of the heterogeneous groups' (MiFID II RTS 20, Recital 2), and simplify the assessment by allowing firms to rely on a similar calculation that they have to perform for the EMIR Clearing Threshold. The removal of references to this test is likely to have a negative impact on UK commodity markets, by requiring firms who are exempted in the EU to become investment firms, and – again – make these markets less competitive in the international context.

- **References to trading venues when regarding the Commission Delegated Regulation (EU) 2021/1833 should be treated as references to only 'UK**

trading venues' for the trading test and capital employed test: not as 'UK and EU trading venues' as proposed in Q45. This is in line with the approach taken in the EU where only EU trading venues' volumes have to be taken into account for the tests by EU firms. Requiring UK firms to include volumes traded on both 'UK and EU trading venues' would result in UK firms having to include more volumes in the calculations than their EU based counterparts, and ultimately put UK firms in a position of disadvantage.

Q26: Do you have any other views on the points outlined above?

No further point to be raised.