12 October 2017

MiFID II: Key issues for corporate users of derivatives

The changes made by MiFID II will have limited or no application to the vast majority of non-financial corporate entities.

However, the new rules and relevant exemptions are complex.

It is therefore important that all corporate users of derivatives are aware of how they operate.

The Markets in Financial Instruments Directive II and the Markets in Financial Instruments Regulation (together "**MiFID II**") will repeal and recast the Markets in Financial Instrument Directive ("**MiFID I**") with effect from 3 January 2018. From that point, MiFID II will be the EU legislation that, amongst other things, provides the regulatory framework for firms which provide investment services or perform investment activities in respect of 'financial instruments'.

The changes made by MiFID II will have limited or no application for the vast majority of non-financial corporate entities, as they will most directly affect investment firms, trading venues and other financial entities. However, for certain corporate users of derivatives, especially commodity derivatives, emissions allowances and related derivatives, the rules may impact the way they carry out their business and may, for example, require regulatory notifications to be made.

It is also possible that an entity which fell outside the scope of MiFID I may fall within scope of MiFID II. This might be as a result of exemptions which it had previously relied upon being amended or removed under MiFID II, additional financial instruments being brought within the scope of MiFID II, or a combination of the two.

Which additional derivatives are within the scope of MiFID II?

Certain physically settled options, futures, swaps and other derivative contracts relating to commodities, including those traded on an Organised Trading Facility ("**OTF**"), certain FX forwards and emissions allowances (and related derivatives) will be classed as financial instruments once MiFID II comes into force, when previously they were not categorised as financial instruments under MiFID I. A corporate entity trading in any of the above instruments will, in principle, be within the scope of MiFID II, unless it is able to rely on an exemption.

The position for corporate entities using commodity derivatives

The 'ancillary activity' exemption

Corporate entities trading commodity derivatives, emissions allowances and related derivatives falling within the scope of MiFID II might be able to avoid becoming authorised if they can satisfy the 'ancillary activities' exemption. This exemption applies where an entity's own account dealing in commodity derivatives is ancillary to its main business, considered on a group basis.

A Commission Delegated Regulation sets out two tests to assess whether this exemption is available. The operation of these tests is complicated and both must be passed for the exemption to be available.

Market Share Test. This test compares the volume of the entity's trading activity in respect a particular class of commodity derivatives with the trading activity in that class of derivative within the EU market as a whole (emissions allowances and related derivatives are treated as their own category). An entity must remain below specified percentage thresholds for all commodity classes (and emissions allowances and related derivatives) in which it trades in order to benefit from the ancillary activity exemption.

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The volume of an entity's trading activity is determined by the gross notional value of its contracts in commodity derivatives, emissions allowances and related derivatives (subject to certain carve-outs).

Hedging derivatives and certain intra-group trades are among some of the transactions which are excluded when assessing the entity's trading activities for the purpose of these tests. MiFID II provides detail as to what constitutes hedging for these purposes and requires that the concept be considered in a manner consistent with the European Markets Infrastructure Regulation ("**EMIR**") (though the concept in MiFID II additionally applies to derivatives traded on a trading venue).

Main Business Test. This test assesses whether the entity's speculative trading activity constitutes a minority of activities at group level. For this test to be satisfied the entity's speculative trading activities (or the related capital employed) must constitute no more than 10% of the total trading activity (or related capital employed) relating to the group's main business. These thresholds are subject to a complicated 'back-stop mechanism' which takes into account that a entity's market size may be sufficiently low to mean that the relevant trading activities are 'ancillary' even where the 10% threshold mentioned above is breached.

The ancillary activity exemption will not be available to an entity if:

- it uses a high frequency algorithmic trading technique;
- the main business of the group is acting as market-maker for commodity derivatives or providing investment services (under MiFID II) or banking activities (under CRD IV); or
- the entity is dealing on its own account when executing client orders in these investments.

Notification of exemption to NCA

Corporate entities that qualify for and rely on the ancillary activity exemption must notify their National Competent Authority ("**NCA**") on an annual basis. In the UK, the Financial Conduct Authority ("**FCA**") opened its online portal in July 2017 to receive such notifications from UK non-financial entities.

Corporate entities relying on the exemption may be requested from time to time to provide their NCA with details of the basis on which they qualify for the exemption. Corporate entities should therefore document the evidence considered and decisions taken which support their use of the exemption.

Position limits and position reporting

MiFID II provides for a cap on the size of a net position which a person (irrespective of whether it is an 'investment firm') can hold in commodity derivatives traded on a venue and economically equivalent OTC contracts ("**EEOTC**"). This is to be assessed on the basis of its aggregate group-wide position, subject to certain exceptions. Corporate entities will have to consider and ensure that their net positions in listed commodity derivatives and EEOTCs are within the position limits set by NCAs.

Non-financial entities that hold positions in commodity derivatives to reduce risks relating to the relevant entity's commercial activities can apply to their NCA for an exemption from this obligation (the 'hedge exemption').

An entity which qualifies for the exemption from the position limits regime will only be able to rely on the exemption if it has made a request to its NCA for that exemption to apply. In the UK, the FCA's online system, 'Connect', can be used to apply for such exemptions.

The positions of non-financial entities which benefit from an exemption will still need to be reported. While it is the investment firms and trading venues that bear the reporting duty under MiFID II in relation to commodity derivatives, emissions allowances and

related derivatives, as a matter of practice corporate users of such instruments will still need to provide certain types of data (e.g. hedge flagging) to trading venues and their investment firm counterparties in order to assist those counterparties to comply with their reporting obligations.

The position for corporate entities using other derivatives

The 'own account' exemption

Any corporate entity which deals in derivatives within the scope of MiFID II (other than commodity derivatives, emissions allowances or related derivatives) may be able to take advantage of an exemption in relation to that dealing if that is the only investment activity or service it undertakes or provides under MiFID II, and certain other conditions are met.

A similar exemption was also available under MiFID I. The exemption will be narrowed by MiFID II such that it will not now exempt:

- dealings in commodity derivatives, emissions allowances or related derivatives;
- persons who apply high-frequency algorithmic trading techniques;
- persons who deal on own account when executing client orders; or
- members of, or participants in, a regular market or Multilateral Trading Facility (or persons who have direct electronic access to a trading venue), except where the transactions entered into on that trading venue are for hedging purposes and the entity is a non-financial entity.

The position for corporate entities using FX forwards and spot FX contracts

FX forwards are generally within the scope of MiFID II. However, FX forwards which are 'connected to payment transactions' will be excluded from the scope of MiFID II, provided that they meet the criteria specified in updated FCA guidance. The exemption available under MiFID II in respect of FX forwards will be much narrower than that provided in the current FCA guidance, under which any FX forward entered into 'for commercial purposes' is outside the scope of MiFID.

Under MiFID II, for an FX transaction to be 'connected to a payment transaction', and therefore outside the scope of MiFID II, it must satisfy all the following tests. The relevant contract must be: a means of payment; physically settled; one to which at least one party is not a Financial Counterparty ("**FC**") for EMIR purposes; entered into to facilitate payment for identifiable goods, services or direct investment; and not traded on a trading venue.

In addition, FX forwards falling within the scope of MiFID II will not include spot FX contracts. There is guidance as to when an FX transaction will be considered a spot contract by reference to when delivery is to be made, with different cut-offs depending on the currencies being exchanged and whether the contract is used for the main purpose of buying or selling a transferable security or unit in a collective investment scheme.

Applying for regulatory authorisation

Corporate entities which intend to continue trading derivatives within the scope of MiFID II on a regular and professional basis must, to the extent they are not exempted or appropriately authorised, apply for regulatory authorisation or a variation of permission from their relevant NCAs.

FCA guidance indicates that applications for such authorisation should have been submitted by 3 July 2017 to ensure that they will be processed before MiFID II comes into force on 3 January 2018.

If a corporate entity gains authorisation under MiFID and is thus considered an 'investment firm', a range of other requirements under MiFID (and subsequently MiFID II), which are outside the scope of this briefing, will apply.

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In this briefing we highlight a number of areas where interdependencies between MiFID and EMIR occur. Please see some of our previous EMIR briefings:

- Gearing up for Clearing Part I, Part II and Part III and December 2015 Update
- Fixing EMIR? The Commission's Proposal
- European Margin Rules for Non-Cleared Derivatives and Margining for Non-cleared Derivatives: get ready to exchange variation margin

Mandatory trading obligation for NFCs+

Even if an entity is not required to obtain an authorisation to carry on business as an investment firm, MiFID II still imposes a mandatory trading obligation on certain entities. This obligation requires certain non-intragroup OTC derivative contracts to be executed on a 'MiFIR trading venue'. For an entity which is not a financial counterparty (**"FC"**) under EMIR, this obligation will only apply where the entity is over the EMIR clearing threshold on a group-wide basis (an **"NFC+"**) and where its counterparty is an FC or another NFC+. It is therefore unlikely to apply to the majority of corporate users of derivatives.

Still unsure? Seek advice

This briefing is intended to give a brief overview of the key issues arising from MiFID II and which might potentially affect corporate users of derivatives. As the new rules come into effect in less than three months' time, anyone still unsure about whether and how the new rules will apply to them should seek advice promptly.

If you would like to discuss further, please do not hesitate to contact a member of our team.

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