Opinion

Draft Regulatory Technical Standard on criteria for establishing when an activity is to be considered ancillary to the main business

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Glossary

ESMA	European Securities and Markets Authority
CRR	Capital Requirements Regulation
RTS	Regulatory Technical Standards
MiFID	Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and the Council
MiFID II	Markets in Financial Instruments Directive – Directive 2014/65/EU of the European Parliament and the Council
RTS 20	Draft regulatory technical standard on criteria for establishing when an activity is to be considered ancillary to the main business

1 Legal Basis

1. In accordance with Article 2(4) of MiFID II, the European Securities and Markets Authority (ESMA) shall develop draft regulatory technical standards to specify, for the purposes of point (j) of paragraph 1 of that Article, the criteria for establishing when the activity of a person is to be considered ancillary to the main business at a group level.

2. The criteria shall take into account at least the following elements:

   a. The need for ancillary activities to constitute a minority of activities at a group level

   b. The size of their trading activity compared to the overall market trading activity in that asset class

3. In determining the extent to which ancillary activities of a person constitute a minority of activities at the group level, Article 2(4) of MiFID II prescribes 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. However, that factor shall in no case be sufficient to demonstrate that the activity is ancillary to the main business of the group.

4. This mandate was developed in the draft Regulatory Technical Standards on the criteria for establishing when an activity is to be considered ancillary to the main business (RTS 20) that were submitted by ESMA to the European Commission in September 2015.

2 Background and Procedure

5. On 28 September 2015, ESMA submitted a draft regulatory standard on criteria for establishing when an activity is to be considered to be ancillary to the main business as draft RTS 20 to the European Commission pursuant to Article 10(1) of Regulation No (EU) 1095/2010 (the ESMA Regulation) and Article 2(4) of MiFID II.

6. In a letter of 14 March 2016, DG FISMA indicated to ESMA its intention to endorse draft RTS 20 subject to certain amendments being made.

7. On 20 April 2016, the Commission confirmed to ESMA its intention to endorse draft RTS 20 subject to a number of changes, in accordance with Article 10(1) of the ESMA Regulation. In particular, the Commission requested ESMA to include, when proportionate and appropriate, a capital based test for groups that have undertaken significant capital investments, relative to their size, in the creation of infrastructure, transportation or production facilities or groups that undertake activities or investments which cannot be hedged in financial markets.

8. ESMA notes that the letter from the Commission was received in excess of the three month period foreseen in Article 10(1) of the ESMA Regulation.

9. Pursuant to Article 10(1) of the ESMA Regulation, this notification from the European Commission triggers a period of six weeks during which ESMA may amend its draft RTS on the basis of the European Commission's proposed amendments and resubmit it in the form of a formal opinion. ESMA shall send a copy of its formal opinion to the European Parliament and to the Council.

10. The amendments proposed by ESMA in RTS 20 have been made on the basis of the draft text submitted by ESMA on 28 September 2015 (see Section 4.4).

11. It is for the Board of Supervisors to adopt such formal opinion in accordance with Article 44(1) of the ESMA Regulation.

3 Executive Summary

12. ESMA still considers that the main business test proposed in draft RTS 20 on 28 September 2015 is in line with the objectives pursued by the exemption contained in Article 2(1)(j) of MiFID II. ESMA does not oppose revising the initial thresholds proposed for this test if the Commission wants to be more cautious in its calibration.

13. ESMA reiterates that the issues identified in its Final Report published in 28 September 2015 regarding the introduction and calibration of a capital based test are still valid: market participants would have to rely on proxies that would have significant variability over time, by type of firm/sector and type of business model. As a result, whether a firm would meet, or not meet the ancillary test, could be very unstable over time. Additionally, given the differences in size and the wide variety of sectors and participants represented in commodity derivatives markets, introducing such a test is not likely to meet the principle of ensuring a level playing field for all market participants across different sectors.

14. Nonetheless, should the Commission deem the introduction of a capital test necessary, ESMA has identified some metrics for a numerator and denominator that could be used by the Commission to construct a capital test as an alternative to the main business test already designed by ESMA in draft RTS 20. ESMA has not proposed a particular solution as each of the metrics identified has a number of drawbacks mentioned in the Final Report.

15. In addition, ESMA has introduced in the attached new version of the RTS a limited number of changes that clarify some of the perceived ambiguities on its application that could have undermined the effectiveness of the RTS.

4 ESMA Opinion

4.1 Main business test as designed by ESMA in RTS 20

16. ESMA understands that the Commission considers the main business test designed by ESMA in Article 3 of draft RTS 20 as not appropriate in all cases where a group's total transaction volume in commodity derivatives may not necessarily reflect accurately the main activity undertaken by a group.

17. ESMA agrees with these considerations and had specifically acknowledged them already in its final report in respect of RTS 20 and in Recital 9 of RTS 20: "In addition, hedging activity cannot be considered a perfect proxy for the commercial activity that the person or group conducts as its main business as it does not take into account other investments of commodity market participants in fixed assets unrelated to derivative markets."

18. For precisely this reason, ESMA recommended that the main business test should not operate solely on the basis of the application of the hedging proxy but should additionally contain a backstop mechanism which recognises that, to be deemed non-ancillary, the trading activity undertaken by the persons within the group should also exceed a certain percentage of one or more of the thresholds set under the trading activity test of Article 2 of draft RTS 20 for each relevant asset class.

19. Article 3 of draft RTS 20 is calibrated so that the higher the percentage of the speculative activity within all trading activity of the group, the lower the threshold of trading activity in commodity derivatives that has to be exceeded in order to fail the ancillary activity test.

20. ESMA considers that calibrating the main business test in this way should provide reasonable confidence that only relevant and sizable participants in European commodity derivative markets are likely to be determined as not to be conducting their speculative trading activities on commodity derivatives as ancillary to their main business.

21. ESMA opted for the main business test due to the severe methodological and practical problems with properly designing and calibrating a capital test as explained further below and also because the test proposed by ESMA can be performed by all firms, including small and medium-sized entities without additional major expense and mostly uses data that will be readily available to those firms under the trading activity test.

22. Therefore, ESMA continues to consider that it developed a solution in draft RTS 20 that is in line with the legislative goals of MiFID II and establishes a meaningful test that strikes an appropriate balance between accuracy and cost.

23. Additionally, ESMA notes the importance placed by the Commission on a cautious approach to the use of the main business test to prevent an overly restrictive application of the test.

24. ESMA agrees that a cautious approach should be taken given that the assessment of whether activities are ancillary to the main business will be based under MiFID II on numerical tests. ESMA had such a cautious approach in mind when setting the thresholds for the trading activity and main business tests as calibrated in draft RTS 20, following an analysis of the limited data available, as described below. If the Commission considers the approach as proposed as not being sufficiently cautious, the relevant thresholds could be adapted.

4.2 Previous analysis of a capital test by ESMA

25. The Commission mentions that the empowerment contained in Article 2(4) of Directive 2014/65/EU refers to the capital employed for carrying out the ancillary activity relative to the capital employed for carrying out the main business. The Commission's letter states that capital employed is an important parameter and introduces the condition that it should be set aside only if manifestly unable to determine the "centre of gravity" of a given group's business activities.

26. ESMA notes that the use of capital is itself a proxy for trading activity and the use of this measure may not capture all active traders. For example, where active traders balance their trading books by the end of the day resulting in no or limited open positions in their overnight balance sheet no or limited capital would be allocated to these activities.

27. The concept of a capital test was extensively explored and analysed by ESMA during the cost-benefit analysis (CBA) of the original draft RTS 20. This work highlighted that there were a number of practical flaws with the proposed draft capital test. Some of the most noticeable drawbacks of the capital test were the potential for market participants to manipulate the test at a point in time by changing the composition of their balance sheets, the need for firms to make estimates to allocate capital to speculative trading in the absence of readily available and public data, the lack of uniformity of segment information across the EU that would make supervisory convergence challenging, and the additional complexity that a capital test may cause to SMEs. ESMA notes that the Commission has also acknowledged some of these points when requesting the introduction of a capital test.

28. As part of the CBA performed in respect of draft RTS 20, ESMA gathered data from market participants active in commodity derivatives markets to determine the feasibility of using a capital test and how it could be applied in practice. ESMA had specifically reached out to non-financial firms across all commodity derivatives sectors to conduct the CBA of the ancillary activity test initially proposed in the ESMA Consultation Paper of December 2014.

29. The limited feedback received (mainly from energy companies) showed that the capital test initially considered would be unreliable given the difficulty respondents reported in allocating accounting capital to trading activities and also could entail significant costs and operational implications for small and medium sized firms (such as the re-organisation of accounting systems and business structure, need for outside support, etc.).

30. Some of the issues identified with using accounting capital were:

    a. the Accounting Directive is not always applicable to these entities and even where is does, it does not mandate a disaggregation of MiFID II and non MiFID II financial instruments between risk-reducing (hedging) and non-risk reducing (speculative) activities;

    b. consolidated IFRS reporting would not identify intra-group transactions;

    c. significant changes would be required to entities' systems and processes to identify and record risk-reducing activities.

31. When accounting capital could not be allocated with the granularity required in the systems of non-financial corporates, a number of proxies were used by respondents to estimate it such as: fair value, collateral, pure mark-to-market (profit & loss) of MiFID II activity, nominal amount of MiFID II activities, value at risk (VaR) and stop-loss limits plus cash amount available to cover initial and variation margins.

32. In the case of fair value, this can be positive or negative depending on the type of activity or the entity level at which trading takes place within a group and there can be high volatility depending on when it is computed. In the case of collateral, some respondents used initial plus variation margins as a measure of capital. However, the amount posted as variation margin can be positive or negative depending on price fluctuations in the commodity derivative, introducing volatility to the calculations.

33. Another limitation of using accounting information is related to the use of segment information to identify "speculative" versus "hedging" activity. Segment information is based on the so-called 'management approach', and depends on how activities are run by management. Therefore the application of this concept might be different for each company. While for some companies it might be easier to present that information in a manner to perform the capital test, it would not be consistent for all companies. The risk of applying different concepts of segment information in different companies or different member states raised a concern related to level playing field and supervisory convergence.

34. In addition, segmentation of trading cannot be imposed under the current EU accounting framework as segments are defined based on how the business is run and not on pre-defined criteria. Depending on the size of the group that information might or might not be easily available.

35. Even for groups reporting under IFRS, the segment information is not necessarily required to be prepared and presented in accordance with IFRS. That means that national accounting standards may be used for determining the segment information. Therefore, looking from a wider European perspective, the figures of capital allocation by different companies would not be comparable.

36. The evidence gathered pointed to the difficulties that ESMA would face in ensuring supervisory convergence (different proxies, standards and ways of presenting the information across the EU, and different business models with diverse balance sheet structures and accounting figures) in using a capital-based test.

37. ESMA also noted an issue of proportionality and level playing field. Based on the information gathered, only the highly sophisticated large corporations active in commodity derivatives markets would easily have the means to perform a sophisticated capital test. Therefore, introducing a capital test as the sole means of demonstrating commodity derivatives activity is ancillary would risk providing major players in commodity derivatives markets with a way to be exempted from authorisation under MiFID II. Conversely, small and medium-sized entities might have been required to apply for MiFID authorisation because they lack the sophistication to prove that they should also be exempt.

38. ESMA considered such an outcome as contrary to the legislative goals of MiFID II as well as other policies pursued by the Commission in the context of the Capital Markets Union.

39. Given the issues identified above in trying to set up an adequate capital test, ESMA was of the view that a capital test could not be satisfactorily implemented and was not likely to meet the principle of ensuring a level playing field for all market participants.

4.3 Incorporation of the changes notified by the Commission

40. ESMA notes that the Commission considers that a capital test should be available to those entities that have undertaken significant capital investments in the creation of infrastructure, transportation and production facilities or who produce, supply or trade physical commodities which cannot be hedged in financial markets.

41. As the ancillary activity test will apply to currently non-regulated entities, ESMA and NCAs do not currently have data to calibrate any capital test beyond the limited sample provided for the CBA or the financial statement data that is available for publicly listed firms. Therefore, the absence of sufficiently comprehensive and reliable data and the short timeframe in which ESMA is asked to develop such a test puts a natural limit on the design and calibration of a capital based test.

42. Based on the information available to ESMA non-financial entities operating in the commodity derivatives market in the EU do not have, in general, readily available and verifiable data on capital used for or actually allocated to speculative commodity derivatives trading.

43. The public financial statements, and their notes, do not generally differentiate speculative from non-speculative commodity derivatives positions, and do not segregate EU from non EU activity.

44. Based on all the considerations made above, ESMA is not proposing a specific ratio or threshold for the capital test but is setting out some options for the Commission to consider as an additional alternative to the main business test already designed by ESMA in draft RTS 20.

45. ESMA identifies several potential metrics for a numerator and denominator that could be used by the Commission to construct a capital test. The Commission would need to assess the meaningfulness of the ratio chosen (numerator / denominator, using the options proposed) and also take into consideration the potential different magnitudes of numerator and denominator when designing a capital test and calibrating a threshold. ESMA notes that for each of these potential metrics it has either limited or no data on which to make a potential calibration.

46. Based on the limited information available and the analysis and calculations performed, ESMA also notes that the differences in outcome between the various suggestions for numerator and denominator, and their various drawbacks in terms of robustness and variability by type of firm, are so significant that the decision of where to set the relevant threshold goes beyond a technical one.

47. ESMA has taken into consideration the desirability of using existing accounting measures in order to minimise the incremental impact on persons. ESMA has also been conscious of the limitations and drawbacks of these measures, in particular in relation to computing capital employed in speculative commodity derivatives activity in the EU. ESMA presents below some of the less problematic metrics that could be used for a numerator and denominator in a potential capital test.

48. For the numerator of the test, which tries to capture the amount of capital employed in speculative commodity derivatives trading in the EU, ESMA has considered the following proxies to estimate capital to have the fewest drawbacks:

    a. **Annual gross notional amount of transactions in commodity derivatives in the EU**, calculated as an average over the past three years excluding the privileged transactions described in Article 2(4) letters a, b and c of MiFID II.

       This option has the advantage that it reuses the data required to conduct the main business test already proposed by ESMA. It directly measures how active an entity is in speculative trading in the commodity derivatives market.

       A disadvantage of this option is that this number is large for most firms and it is not ‘capital’ per se. ESMA notes that using gross notional as a proxy for capital is likely to significantly overstate the amount of capital needed to support a particular portfolio, and potentially be quite large relative to measures of accounting capital in the main business. Calibration of the test would therefore need to be sensitive to this difference of magnitude between numerator and denominator in order to be sufficiently cautious.

       The capital element of the test would be introduced in this case via the denominator only. The significant investments in plants and machinery that the Commission seeks to incorporate into the assessment of whether an activity is ancillary would be incorporated in the denominator, making it more likely that an entity with significant investments in its commercial business would be exempt.

b. **A simplified approach derived from the CRR.** This approach estimates capital using the formula below, to identify a proxy for capital based on the minimum amount of equity capital that a non-financial firm would be required to hold against the market risk inherent in its speculative positions in commodity derivatives in the EU. To that end, capital could be estimated by adding up the capital required for each position in commodity derivatives according to the following formula:

   i. 15 % of the net position, long or short, multiplied by the spot price for the commodity derivative;

   ii. 3 % of the gross position, long plus short, multiplied by the spot price for the commodity derivative.

   This option has the advantage that there is a European regime already existing and calibrated to a significant level of detail. However, it has to be noted that the calibration in CRR was made for financial firms, as opposed to the non-financial firms that would have to use this approach to estimate the amount of capital to include as numerator of a capital test.

   One drawback is that the CRR would be unfamiliar to the non-financial firms conducting these calculations. As a consequence, ongoing need for detailed guidance of how to apply the rules for different commodity derivatives and different types of transactions should be expected. Some of this guidance may need to be coordinated with the EBA.

   Another drawback would be requiring entities to use a methodology derived from a regulation from which they are seeking exemption (albeit they would have to use the CRR methodology if they did not benefit from the exemption and would arguably therefore face no additional burden).

   In terms of calibration, ESMA lacks visibility as there are no readily available data on gross and net positions held by non-financial firms over a period of time.

   Finally, the NCAs that are not already responsible for supervising entities using CRR would have to develop or access the expertise to challenge any submission. ESMA also recognises that a ‘CRR like’ calculation would give a hypothetical minimum amount of equity capital required to support a particular derivatives position if the firm were subject to CRR rather than a measure of the capital actually employed to conduct speculative trading activity in commodity derivatives markets.

ESMA notes that CRR also provides a calibration of whether an activity in agricultural commodities business is ancillary to an investment firm's/bank's main business[1], alongside some other requirements.

c. The Commission's letter also refers to using **marked-to-market derivatives positions**. This option would require judgments as to how objectively to take into account both positive and negative position values within a portfolio, and how each position relates to capital employed, as well as acknowledging that the amounts calculated would depend entirely upon, and potentially vary significantly with market prices at a given point of time. Also, the Commission would have to be mindful that for some large portfolios the net marked to market amounts, by including significant long and short positions, could be close to zero.

d. Finally, ESMA considered using a **measure of margin or collateral**. A margin-based method has the advantage that for exchange traded commodity derivatives well-established and robust methods of calculation such as SPAN are available. However, using the amount of margin actually posted has the drawbacks that margin required by counterparties is usually calculated based on the overall portfolio (which includes both risk reducing and non-risk reducing transactions), and also that in OTC transactions, which are commonplace in some commodity derivatives markets, collateral is not always posted. This outcome would create incentives to avoid exchange-traded and centrally cleared derivatives, and to avoid margin requirements for non-cleared OTC derivatives, therefore being inconsistent with other policy measures.

e. An alternative margin-based approach would be to use the **methodology established in the ESA's joint draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP** under Article 11(15) of Regulation (EU) No 648/2012 to calculate a hypothetical amount of margin for a speculative commodity derivatives position. This approach could be relatively easily adjusted to take into account the lower margin period of risk for exchange-traded derivatives. There would be no change to actual margin requirements paid and received by market participants.

The challenge here would be to achieve a proper calibration of a capital test based on this measure given the lack of data at this stage on commodity derivatives positions of non-financial entities over a longer period of time.

49. For the denominator, ESMA considers the following two metrics for the capital used by non-financial firms in their main business to have the fewest drawbacks:

a. The disclosed figure for '**Property, plant and equipment' (PP&E**) from the asset side of the audited and published balance sheet of the entity or group.

[1] See Article 356 of CRR on Ancillary commodities business

PP&E would have the advantage of reflecting most closely the significant investments an entity has undertaken in its commercial activities which is in line with the Commission's intention. The total figure for PP&E can be verified by looking at the entity's financial statements.

This option would have the drawback that different entities have different balance sheet structures depending on the commodities in which they trade and the way in which they conduct their commercial activities. Companies performing real economy functions that act as intermediaries, or, for example, lease or rent rather than own assets may have small balance sheets and therefore PP&E figures. ESMA made a preliminary analysis of this approach using the data received for the technical standards CBA, where it computed gross notional traded in speculative commodity derivatives/PP&E. However, the data did not provide clear direction on how to calibrate such a test, as there was wide variation between firms in the resulting ratio.

b. Using **'total equity' or other wider measure of financing** from the liability side of the balance sheet.

   Total equity would reflect the overall equity capital the group has on a consolidated basis. The data is readily available on the audited and published balance sheet.

   The drawback would be that it would not reflect investments made in commercial assets where those are financed with a combination of equity and long term debt. Moreover, using this option could adversely impact the financing structure employed by the entity as regulatory treatment could become the driver of capital structures. Additionally, different tax treatments of long term debt among different Member States that encourage a different debt/equity structure would be detrimental to a harmonised application of the test across the Union.

   A wider measure of financing may therefore be preferable. One problem with using any measure from the liability side of the balance sheet, however, is that this financing may not be funding just the main business activity, or investments in plants, infrastructure and machinery as it can include capital used to support speculative activity in commodity derivatives.

50. ESMA has also considered how a capital test would sit alongside the main business test as designed by ESMA in draft RTS 20 in September 2015, and in particular whether it should be optional or mandatory to all firms.

51. ESMA concludes that entities should have the option to choose between performing the original main business test based on trading activity and a capital test. Making one test mandatory for one set of firms and a different test mandatory for other firms may distort competition and be discriminatory, particularly in the absence of data to conduct a CBA and undertake a proper calibration.

52. ESMA considers that a capital test may be easier to perform by larger firms particularly if a more complex design of a capital test is adopted. Small and medium-sized enterprises may find it easier to apply the main business test proposed by ESMA in draft RTS 20 in September 2015. ESMA considers it essential that small and medium-sized enterprises are not put at a disadvantage by the incorporation of a complex capital test into draft RTS 20.

53. Should the Commission introduce a capital based test, ESMA recommends the Commission calibrates its thresholds carefully and, if necessary, modifies the thresholds for the main business test proposed by ESMA, in order to ensure the consistency of both tests and that small and medium-sized entities are not put at a disadvantage.

4.4 Changes to the existing draft

54. ESMA has taken this opportunity to amend the text of draft RTS 20 in a limited number of places which are marked in the annexed draft standard and that are not related to the notification by the European Commission.

55. The reason for this is that ESMA has been made aware by stakeholders that certain elements of the calculation mechanics for the existing ancillary tests were not entirely clear and stakeholders had brought different possible interpretations to ESMA’s attention.

56. In particular, ESMA has now clarified that the numerator and the denominator of the trading activity test (Article 2) and the main business test (Article 3(4)) shall be calculated based only on trading in the Union in commodity derivatives by persons within a group.

57. ESMA has also clarified that the calculation shall not include transactions by entities that are already authorised under MIFID. It is essential for the application of the exemption regime to consider only the activity of non-authorised entities as activity by authorised entities is already subject to appropriate regulation. ESMA has calibrated the test proposed on the assumption that the aggregation will work in this way.

58. This approach will also avoid the problem that, by considering in the calculations the significant speculative trading activity of an already authorised MiFID investment firm, every legal entity within the group would require such authorisation. Such an outcome would appear to impose a disproportionate burden on the non-financial companies within a group.

59. ESMA has made changes to the dates in the RTS to take account of the co-legislators’ agreement to delay the implementation of MiFID II.