FCA proposes revised framework for commodity derivatives

HOT TOPIC

December 2023

Highlights

Analysis of the FCA's proposals to reform the regulatory framework for commodity derivatives, placing greater emphasis on trading venues to fulfil a number of functions, and clarifying when trading activity can be considered ancillary to a firm's main business.

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Summary

The FCA published its proposals for revising the commodity derivatives framework on 4 December 2023. CP 23/27 covers the regimes for position limits, position management controls, exemptions from position limits, and amendments to the ancillary activities exemption.

Changes to the regulatory framework were proposed in HM Treasury's (HMT's) Wholesale Markets Review in 2021. Since then, a number of external events have informed the FCA's thinking and related proposals.

Reforms to the commodity derivatives framework will affect several types of market participant, including trading venues, financial firms trading commodity derivatives and emission allowances, and non-financial firms which are active in those markets.

Context

The FCA states its aim in proposing changes to the commodity derivatives framework is to bring together the reforms proposed in the Wholesale Markets Review (WMR) with changes that it sees as necessary to address risks that may have contributed to recent periods of volatility and instability in certain commodity markets.

These events include the March 2022 episode of disorderly trading on the London Metal Exchange's (LME) Nickel market, heightened geopolitical risks, and volatility in certain markets leading to liquidity and credit stresses. As a result, regulators have increased their attention on commodity markets in recent times.

In the UK, a number of changes to the regulatory framework have already been made as part of Brexit preparations and via the Financial Services and Markets Act (FSMA) 2023.

Internationally, the International Organisation of Securities Commissions (IOSCO) has updated its Principles for the Regulation and Supervision of Commodity Derivatives Markets, in part to reflect these developments.

UK commodity derivatives markets play an important role in the pricing of commodities globally, as well as providing an important link between financial markets and the real economy. As such, the impact of the FCA's proposals will be felt by a large number of market participants and end users.

What is changing?

The CP proposes changes to the current regimes for position limits, position management controls, position limit exemptions, the reporting regime, and the ancillary activities test.

Many of the proposals transfer responsibility for operating aspects of the current framework from the FCA to trading venues. This will result in additional supervisory requirements on trading venues. The FCA commits to a 'robust and proactive' approach to supervising how the rules are being applied in practice.

Among other things, the reforms aim to provide trading venues with greater visibility of members' over-the-counter (OTC) positions, and those of their clients, to support effective risk management.

The FCA also aims to streamline regulatory requirements, as well as the 'complex' structure of relevant rules. The FCA will improve firms' ease of reference and identification of regulatory requirements by bringing under the Market Conduct Sourcebook (MAR) in the FCA Handbook the various rules, directions, guidance and signposting to relevant legislation.

Position limits

FSMA 2023 transferred the responsibility for setting position limits from the FCA to trading venues, and gave the FCA rulemaking powers in relation to how trading venues should set and apply those limits. The FCA retains the power, under certain circumstances, to set position limits and take other actions in relation to position limits.

Position limits apply to commodity derivatives traded on a trading venue, and economically equivalent OTC contracts. Under MiFID II, this captured around 800 contracts, however the FCA reduced the scope of the regime to physically settled contracts and cash settled agricultural contracts in 2021.

The FCA proposes that position limits should apply only to contracts that it deems 'critical', based on a number of criteria which reflect the risks those contracts pose to UK markets. Those contracts will be published via a register on the FCA's website, and are included in the CP.

Table 1: List of critical contracts to be subject to position limits

Settlement method	Contract
Physical	LME Aluminium; LME Copper; LME Lead; LME Nickel; LME Tin; LME Zinc; London Cocoa Futures; Robusta Coffee Futures; White Sugar Futures; UK Feed Wheat Futures; Low Sulphur Gasoil Futures; UK Natural Gas Futures.
Cash	T-West Texas Intermediate
Exchange-for-physical, with option to cash settle	Brent Crude Futures.

Position limits will also apply to 'related' contracts as specified by trading venues. This will include, at a minimum, any commodity derivative traded on a UK trading venue whose settlement price is directly or indirectly linked to the settlement price of a critical contract, or that can result in position or delivery obligations in the critical contract or its related contracts.

The criteria the FCA will have with regard to when determining critical contracts are:

- the settlement method (e.g. cash-settled or physically-settled)
- the size of the derivative market compared with the underlying physical commodity, and the robustness of the reference price used to settle contracts
- the type of underlying commodity and its impact on end-users
- the size of the commodity derivative market (e.g. level of open interest, traded volumes, and number of market participants).

Position limits will apply to participants' net positions in the critical contracts as well as related contracts, subject to certain exceptions. Positions should be aggregated at group level where a parent undertaking can control the use of subsidiary positions.

The FCA will provide market participants 45 days' notice before including new contracts in the register of critical contracts.

Setting position limits

With regards to the setting of position limits, the FCA notes that MiFID II required a specific methodology which used fixed thresholds and parameters in order to promote harmonisation across the EU.

Going forward, the FCA proposes to allow trading venues to calibrate position limits according to the features of specific markets without requiring fixed thresholds. The FCA will supervise how trading venues apply their position limits, and expects them to apply different limits to spot months and other months given the higher potential for abusive practices as contracts get closer to expiry.

Trading venues will be required to review their position limits at least annually, as well as when a change occurs that significantly impacts the market. Trading venues will also be required to develop methodologies for setting their position limits, which must take into account certain criteria as specified by the FCA. These include:

- the deliverable supply of the underlying commodity
- aggregate open interest and its relationship with the deliverable supply
- maturity (ie, spot month vs other months)
- volatility in relevant markets and the ability to manage risks
- liquidity in relevant markets
- the ability to make or take delivery of the underlying, and the characteristics of its market.

Exemptions from position limits

The FCA proposes that trading venues will be responsible for granting and monitoring exemptions.

Non-financial firms can currently benefit from an exemption from position limits when hedging against risks arising from their commercial activities. The FCA is proposing that trading venues will only be able to grant this exemption when they are satisfied that exempt positions can be reasonably managed, including the ability for those positions to be unwound in times of market stress.

The FCA states that trading venues need a clear and concise view of the commercial activities of non-financial firms and how the commodity derivative for which the exemption is being requested mitigates its risks. Non-financial firms would therefore be required to provide trading venues with information about the positions they hold, including in related OTC commodity derivatives, and those they intend to hold over the year ahead.

In 2020, the FCA said it would not take enforcement action against financial firms for breaches of position limits as a result of fulfilling liquidity provision obligations on a trading venue. The FCA is proposing to codify this approach via a new exemption from the regime.

As originally proposed in the WMR, the FCA is also consulting on an additional 'pass-through' exemption for financial firms providing risk mitigation services to non-financial firms hedging their commercial risks. The purpose of this exemption is to remove a potential barrier to financial firms being able to facilitate hedging activity. When using this exemption, the FCA expects financial firms' futures and OTC positions to be substantially related.

Trading venues would be required to consider establishing an 'exemption ceiling' which acts as a limit on the size of a participant's exempt positions. Should market participants breach that ceiling, additional reporting requirements would apply. Trading venues would be required to notify the FCA where exemption ceilings have been applied, and include information about breaches in an annual report to the FCA.

Position management controls

The FCA's proposals strengthen the requirements on trading venues with regards to their oversight and surveillance of their position management controls.

These changes were not originally proposed in the WMR. The FCA states however that recent disruption in certain commodity markets has highlighted the need for strengthened controls.

The FCA notes that trading venues currently operate a variety of controls aimed at preventing or mitigating the risk of disorderly markets. Its proposals cover:

Accountability thresholds

The FCA proposes to require trading venues to establish accountability thresholds, which sit below the level of position limits and help to monitor the build-up of large positions.

The thresholds will apply to all critical contracts and their related contracts, to which the position limit regime will also apply.

Both position limits and accountability thresholds will apply at the level of the end client.

If a participant exceeds the accountability threshold, the FCA would require trading venues to consider a range of information when investigating. This should include the participant's historic and anticipated position sizes, knowledge of its exemptions, the extent and quality of the participant's engagement with the trading venue, the complexity of the delivery process if the contract in question is physically settled, and peer comparisons.

Trading venues would be required to review their accountability thresholds, and the methodology for setting them, annually or when significant changes occur. The FCA must be notified prior to implementing the methodology and setting the thresholds.

Position reporting

The FCA notes that trading venues require access to more extensive data on members' related OTC positions to properly administer position limits and position management controls. Current reporting under UK EMIR and UK MiFID II provides only a partial picture.

The FCA proposes to introduce an obligation for trading venues to receive from their members and their clients, up to and including the end client, additional reporting when certain conditions are met.

The FCA establishes a set of minimum criteria that trading venues should use to trigger additional reporting requirements. Such additional reporting must encompass (i) position reporting in related OTC derivative contracts (ii) position reporting in related contracts traded on overseas trading venues (as determined by the trading venue).

The FCA does not propose to specify the format in which additional reporting must be provided by either the trading venue or the member and its clients.

Ancillary activities exemption

Under the WMR, HMT committed to simplifying the ancillary activities exemption from authorisation by moving to a qualitative test.

Firms which deal in commodity derivatives, emission allowances or derivatives of those instruments can benefit from the exemption if they meet certain criteria. The current test that firms must perform and meet in order to rely on the exemption is based around two components which assess the absolute and relative size of the firm's trading activities.

Intra-group, hedging and liquidity provision transactions are excluded from the related calculations firms must perform.

The FCA issued a statement in January 2023 clarifying how firms can continue to rely on the ancillary activities exemption where the data needed to perform the necessary tests are not available. In this CP, the FCA clarifies that its statement will continue to apply for the year ahead (2024-2025).

The EU made changes, post-Brexit, to its test for the ancillary activities exemption. The test remains quantitative, and requires firms to perform a 'main business test' and a 'de minimis' threshold test.

To meet HMT's commitment to provide a qualitative test, the FCA proposes to issue guidance covering its understanding of 'ancillary' - which is something related and subordinate to the main business of the group - and providing confirmation that firms can have regard to the trading and capital employed thresholds used in the EU test to judge what is ancillary.

The requirement to notify the FCA annually when firms rely on the ancillary activities exemption has been removed. The FCA may, however, still require firms to provide related information to it on an ad hoc basis.

What is not covered?

The CP does not take forward a number of issues that were originally proposed in HMT's first WMR publication, namely:

- The changes to the FCA's perimeter do not include any proposed changes to the oil market participant (OMP) and energy market participant (EMP) regimes. Feedback to the WMR noted mixed views on the value of amending this part of the regulatory framework. HMT noted that while it and the FCA would continue to review the regime, no imminent changes were planned.
- Neither this CP nor legislation introduced post-Brexit reintroduce the previous 'commodity dealer exemption' as a basis for firms to be exempted from authorisation. The FCA notes the commodity dealer exemption was broader than the corresponding parts of the ancillary activity exemption in MiFID II, and would have the unintended effect of exempting a set of financial firms from the requirement for authorisation.

What do firms need to do?

Given the range of in-scope market participants, firms will need to consider how the FCA's proposals will affect their business models, strategies, trading activities, operational processes, regulatory controls and reporting requirements.

Trading venues which admit to trading commodity derivatives will need to assess their current risk management frameworks, systems and rules to identify any gaps between current practices and the FCA's proposals.

In particular, trading venues will need to review their member oversight arrangements, existing trading control and position management frameworks, and market risk analysis capabilities. Trading venues should also review their arrangements for reporting to the FCA.

Firms which are active in commodity derivatives markets, including commercial users, will need to assess whether their operational systems and processes will enable compliance with the FCA's proposals in relation to additional reporting obligations. In particular, firms should review their arrangements for reporting OTC positions and positions in related contracts on overseas trading venues.

Firms should consider whether their trading activities will fall within scope of the position limits and accountability thresholds regimes, and what impact this will have on a range of processes including treasury financing activities, reporting requirements, and internal monitoring.

Firms which currently rely on the ancillary activities exemption will need to assess whether they can continue to do so under the revised test, and how they can demonstrate their eligibility for the exemption to the FCA if required to do so.

Market participants should provide any relevant comments to the FCA by 16 February 2024, noting that a further consultation on transparency requirements in fixed income and derivatives markets is expected from the FCA before the end of the year.

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Next steps

The consultation is open for comment until 16 February 2024.

The FCA has committed to providing a transitional period, to provide firms with time to make any necessary changes. The transitional period will last for one year after the FCA's final rules have been made.