



EUROPEAN COMMISSION

Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Director General

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Mr Steven Maijor
Chairman
European Securities and Markets
Authority - ESMA
103, rue de Grenelle
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Dear Mr Maijor,

On 28 September 2015, ESMA submitted to the European Commission (Commission) the draft regulatory technical standard (draft RTS 20) on the criteria to establish when an activity is considered to be ancillary to the main business pursuant to Article 2(4) of Directive 2014/65/EU (MIFID II).

MIFID II exempts persons dealing on own account or providing investment services to clients in commodity derivatives provided that, *inter alia* this is an activity that is ancillary to their main business, determined on a group level, and that the main business is not the provision of investment services or banking services.

ESMA's draft RTS lay down the criteria to establish when an activity in commodity derivatives is to be considered as ancillary to the main business at group level. The RTS lays down two tests which need to be met in order for an activity to be considered ancillary:

- A market share test, and its associated trading activity thresholds, which compares the level of a person's trading activity against the overall trading activity in the Union on an asset class basis.
- A main business test, and its associated thresholds, which determines the extent to which the activity of the persons within the group who trade on own account or provide investment services in commodity derivatives constitute a minority of activities at group level.

ESMA's draft RTS proposes that the main business test is conducted by determining the ratio of non-hedging transactions to total transactions in commodity derivatives (including both hedging and non-hedging transactions) that a group engages in. ESMA argues that this ratio is an appropriate reflection of the main activity of a group. In arriving at this conclusion, ESMA assumes that a group is able to hedge all risks associated with its commercial activity by means of commodity derivatives. In ESMA's view, the size of the total turnover in commodity derivatives is a reliable proxy for the size of the commercial activity conducted by a group.

I would therefore like to inform you of the Commission's intention to endorse the standard on ancillary activities once certain amendments are made.

Overall, the Commission is supportive of the general approach that ESMA has taken to this standard. However, in the areas set out below, the Commission considers that in the absence of comprehensive trading data, the ESMA's proposal for the main business test on the basis of the total turnover as a proxy to commercial activity may result in an overly restrictive application of the test. Until such data is available, it would therefore be justified to take a more cautious approach for the calibration in the initial years. Such an approach is also consistent with the concerns raised by the European Parliament's ECON Committee and some members of the Council.

To this end, the Commission considers that the proposed main business test should include a wider range of factors when determining the extent to which activities constitute a minority of activities at a group level. In particular, 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 capital employed is an important parameter foreseen by the co-legislators to measure the proportion of financial and non-financial activities of a group that should only be set aside if it is manifestly unable to determine the "centre of gravity" of a given group's business activities.

In light of the above, the Commission considers that the trading ratio that ESMA proposes in order to determine when an activity constitutes a minority of activities is not the appropriate test for all cases and for all groups potentially affected by the ancillary activities test. A group's total transaction volume in commodity derivatives is not necessarily an accurate reflection of the main activity undertaken by that group. For such cases, it would therefore not be justified to use the test based on the trading activity only. The standard as proposed by ESMA would therefore not be in line with the objective pursued by the exemption contained in Article 2(1)(j) Directive 2014/65/EU because the test would not, in all instances, accurately reflect a group's main activities.

The following considerations are relevant in this respect:

- The ratio employed by ESMA is not invariably representative of a group's commercial activity because commercial entities employ various means to hedge their business activity, including physical or financial means other than commodity derivatives.
- In some instances, significant parts of a commercial activity cannot be hedged at all.
- Furthermore, the test proposed by ESMA does not take into account a group's commercial activities which do not require any hedging or for which no derivatives-based hedging tools exist. In many cases, groups cannot use financial instruments to hedge their commercial activity due to the lack of such instruments.
- The proposed test also neglects often considerable investments in assets conducted by entities and groups that are not reflected in corresponding hedging positions.

The Commission therefore considers that, in order for the draft RTS submitted by ESMA to take full account of the objective of, and the mandate contained in, Article 2 of Directive 2014/65/EU, groups that have undertaken significant capital investments, relative to their size, in the creation of infrastructure, transportation and production facilities and investments which cannot be hedged in financial market, when proportionate and appropriate, should measure their main and ancillary activity using a capital based test.

The capital based test might be best suited to:

- Groups that can demonstrate significant capital investments in assets, such as plants, infrastructure and machinery, relative to the size of their group as evidenced by financial statements.
- Groups that produce, supply or trade physical commodities for which there is no liquid financial market to hedge these physical transactions. The liquidity of such financial markets should be consistent with determination made for transparency purposes under MIFID.

Small and medium companies should not be required to use the capital based test in cases where calculations of the capital for the purpose of the compliance with the main business test would result in excessive costs for these companies. In those cases it is justified and proportionate to use the trading test.

ESMA should develop a methodology to allocate capital between the main business activity and the ancillary activity so as to allow groups to demonstrate that the ancillary activity constitutes a minority of activities at a group level.

For each of the main and ancillary activity capital should be measured using one of the below, as appropriate:

- Measures specified in financial statements such as the total shareholder funds, total long term liabilities, total intangible assets, property plant and equipment, mark-to-market derivative positions;
- Measures used to calculate regulatory capital such as provided for in Regulation (EU) No 575/2013 of the European Parliament and the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

In this regard, ESMA should develop a capital allocation measure which is verifiable, non-discriminatory, proportionate, and cannot easily be manipulated. The capital methodology developed should be able to take into consideration non-financial long-term assets such as plants, infrastructure and machinery.

I therefore inform you that the Commission, acting in accordance with the procedure set out in the fifth and sixth subparagraphs of Article 10(1) of Regulation (EU) No 1095/2010, intends to endorse the draft regulatory technical standard submitted by ESMA on the criteria to establish when an activity is considered to be ancillary to the main business pursuant to Article 2(4) of Directive 2014/65/EU with these suggested amendments.

The Commission is very grateful for the work that has been undertaken by ESMA and its members to deliver the MiFID II level II package of measures. This is a substantial package that has been delivered professionally and to a high standard. The standards that have been submitted, if endorsed by the co-legislators, will contribute to better functioning markets in the EU with a high level of investor protection.

Yours sincerely,



Olivier Guersent