2 December 2016

MiFID II – Commodity Derivatives Position Reporting

Executive Summary

The associations believe that it is important for ESMA to provide guidance on the obligations imposed under Article 58 MiFID II, in order to assist reporting entities with the development of systems and controls necessary to ensure compliance with the position reporting regime. As further discussed below, we would be grateful if ESMA could clarify certain points regarding the scope of the position reporting regime. In particular:

- how firms should interpret references to *'client'* and *'end client'* in Article 58 MiFID II, and in what circumstances a reporting entity would be obliged to include the positions held by clients and the clients of those clients until the end client is reached, in the reporting entity's position reports;
- how ESMA proposes to address the legal issues that potentially arise from the reporting of positions held by clients and the clients of those clients until the end client is reached;
- what steps ESMA intends to take in order to eradicate potentially duplicative reporting obligations that would otherwise exist under Article 58 MiFID II; and
- whether ESMA agrees that, for the reasons set out below, position reporting should be conducted on a T+2 basis.

Meaning of 'client' and 'end client'

Articles 58(2) and 58(3) MiFID II require reporting entities to include their *'own positions'*, as well as the positions of their *"clients and the clients of those clients, until the end client is reached"* in their position reports. Although we are not aware of any definition of the term *'end client'* in the relevant legislation, we do note that Article 4(1)(9) MiFID II states that *"'client' means any natural or legal person to whom an investment firm provides investment or ancillary services"*. As with any reference to *'client'*, we believe that any reference to *'end client'* in Article 58 MiFID II should be interpreted in accordance with the Article 4(1)(9) MiFID II definition. Accordingly, for an entity to be a *'client'* it must receive investment or ancillary services from an investment firm. If such a *'client'* is also an investment firm (**"Entity B"**), then any entity to which Entity B provides investment or ancillary services will also be a *'client'*. If Entity B does not provide any investment or ancillary services to any entity, then Entity

B will be the 'end client'. If an entity is a 'client' but is not an investment firm (**"Entity C"**), then it must always be the 'end client' as, in light of Article 4(1)(9) MiFID II, Entity C would not be "an investment firm [providing] investment or ancillary services" to any other entity.

On this interpretation, reports made under Article 58(2) MiFID II should include an investment firm's own positions, those of any entity to whom it provides investment or ancillary services ("**Client X**"), those of any entity to whom Client X provides investment or ancillary services, and so on down the chain. Consequently, we understand that the final link in the chain will be reached and the 'end client' will be identified upon reaching the first client that is either: (i) not an investment firm (as by definition it cannot have a *'client'* itself) or; (ii) is an investment firm but does not provide any further entity with any investment or ancillary services.

However, not every position taken in a commodity derivative, emission allowance or derivative thereof that is traded on a trading venue or in an economically equivalent OTC contract ("**EEOTC**") will involve a client. For example, where an investment firm that is dealing on own account enters into an EEOTC with another investment firm, neither firm may be providing investment or ancillary services to the other. In these circumstances, we understand that each investment firm would only be required to report its own positions and not those of the other firm which is its trading counterparty, or those of any client that the trading counterparty may have.

Q.1 Does ESMA agree that references to 'client' and 'end client' in Article 58 MiFID II should be interpreted in light of the Article 4(1)(9) MiFID II definition of 'client'?

Q.2 Where Article 58 MiFID II imposes a requirement on an entity to include the positions of its "clients and the clients of those clients, until the end client is reached", does ESMA agree that the entity's report should include its own positions, those of any entity to whom it provides investment or ancillary services ("Client X"), those of any entity to whom Client X provides investment or ancillary services, and so on down the chain?

Q.3 Does ESMA agree that where an investment firm ("Firm A") is dealing on own account and enters into an EEOTC with another investment firm ("Firm B") without providing investment or ancillary services to Firm B, Firm A's position report should only include its own positions (and not those of Firm B, or those of any client that Firm B may have)?

Legal issues relating to the reporting of client positions

The obligation to report client positions under Article 58 MiFID II raises a number of legal challenges and uncertainties for reporting entities. We note, for example, that MiFID II does not contain any provision that is equivalent to Article 9(4) EMIR, which confirms that a counterparty or a CCP (or any entity acting on their behalf) that reports the details of a derivative contract to a trade repository or

to ESMA *"shall not be considered in breach of any restriction on disclosure of information imposed by that contract or by any legislative, regulatory or administrative provisions"*. Moreover, the fact that the reporting entity may have no direct contractual relationship with the non-EU end clients gives rise to practical difficulties in attempting to obtain confidential information from them regarding the positions that they hold. The provision of such information could also give rise to breaches of applicable laws and regulations regarding data protection and banking secrecy. In attempting to comply with their obligations under Article 58 MiFID II, reporting entities risk breaching those applicable laws and regulations, in some circumstances such breaches may constitute criminal offences.

In order to ensure confidentiality, we understand that there have been proposals for the development of an IT solution that would encrypt the information relating to end clients. However, we do not consider such a proposal to be viable for a number of reasons:

i. it would not necessarily address all of the legal issues identified above (for example, regarding bank secrecy);
ii. it is not clear whether such a system would be enforceable against non-EU end clients;
iii. the implementation of the IT solution is likely to prove challenging for budgetary and operational reasons for both market participants and regulators. In addition, it would also bring complexity to the IT architecture that has been built-up in the past few years in view of the reporting requirements under EMIR, REMIT and MiFID; and
iv. it is questionable as to how the encrypted end client data would fit in with the internationally agreed LEI standard.

For these reasons, we believe it is appropriate for reporting entities to take reasonable steps to obtain information regarding the positions held by end clients. However, we would be grateful if ESMA could confirm that a reporting entity would not be required to report the positions of its clients and the clients of those clients until the end client is reached, where to do so would be a breach of an applicable law or regulation.

Q.4 How does ESMA proposes to address the breaches of applicable non-EU laws and regulations, regarding data protection and bank secrecy, that may potentially arise from the reporting of client and end client positions?

Potentially duplicative reporting

We understand that the reporting obligation imposed under Article 58(2) MiFID II applies to all positions (i.e. both trading venue and EEOTC positions). In our view, this would result in an element of duplicative reporting since the entity operating the trading venue would also provide the competent authority with a breakdown of the trading venue positions, pursuant to Article 58(1)(b) MiFID II (and as supplied to it pursuant to Article 58(3) MiFID II). We note that in the Final Report (ESMA/2015/1858) it is stated that *"ESMA may also explore at Level 3 ways in which it is possible for*

investment firms to meet their obligations for reporting exchange traded derivatives under Article 58(2) by delegating part of their reporting to the entities that are obliged to report the same positions in instruments to the same NCA. This would have the benefits of reducing the operational tasks of reporting while also avoiding the inherent duplication of position reports for commodity derivatives, emission allowances and derivatives thereof that have been traded on a trading venue that would otherwise occur" (section 5.1.14, page 23). We believe that a firm should be allowed to comply with the obligation to report positions under Article 58(2) MiFID II by delegating the reporting obligation to the entity operating the relevant trading venue (or to a third-party provider) and would therefore strongly encourage ESMA to undertake this exploration at Level 3. In addition, we ask ESMA to consider whether delegation should also be permitted in respect of the Article 58(3) MiFID II reporting obligation, in order to maximise consistency between the two provisions.

Furthermore, the Final Report also states that *"ESMA's intention would be for trading venues and investment firms to use identical templates in order to facilitate automated reporting systems so that reports can be processed and aggregated efficiently. ESMA would therefore encourage trading venues also to use the reporting format established in Annex 2 of this technical standard and may address this issue in the future on Level 3"* (Section 5.1.13, page 22). We agree that trading venues and investment firms should use identical templates and would support the publishing of Level 3 guidance that requires position reports submitted under the requirements of Articles 58(1)(b) to adhere to the template provided for Article 58(2) (set out in Table 2, Annex II of draft ITS 4 within the Final Report). In addition, we would encourage ESMA to publish Level 3 guidance stating that the reports submitted in accordance with Article 58(3) should also adhere to the template provided for Article 58(2).

Q.5 What steps does ESMA intend to take in order to eradicate potentially duplicative reporting obligations under Article 58 MiFID II?

Timing of commodity derivatives position reporting

Both Articles 58(2) and 58(3) clarify the sequencing of reporting by requiring the reporting entity to report "*at least on a daily basis*".

In order to meet these obligations, the reporting entity must first identify all the positions of its branches and its clients (including those located outside of the European Union) and reconcile those positions to ensure they are correct by the specified cut-off time of the relevant national competent authority. In our view, reporting positions prior to the completion of back office procedures may result in reporting errors that would need to be corrected once these processes have been completed. As market participants may still be reconciling, editing and rerunning positions on T+1, we believe that reporting should be conducted on a T+2 basis, in order to allow sufficient time to report with a higher degree of accuracy.

While we are aware that exchanges and other regulators (e.g. the CFTC) accept position reporting on an end of T+1 basis for futures, we also note that the CFTC requires T+2 reporting for OTC positions.

We believe that for consistency, the Article 58(2) and 58(3) reporting obligations should have identical reporting deadlines and, in light of the issues surrounding reporting OTC positions, a reporting deadline of T+2 would be appropriate.

We note that in its consultation on MiFID II implementation (CP 16/19), the UK FCA proposes that the reporting is done by 5.00 pm UK time on T+1. However, this proposal does not seem to consider the impact of reporting OTC positions.

Q.6 Does ESMA agree that, in light of the issues surrounding reporting of positions, all position reporting should be conducted on a T+2 basis?

Conclusion

The issues identified in this letter are of key importance to reporting entities in order to understand the obligations imposed by Article 58 MiFID II. We would therefore be grateful if ESMA could confirm that the views set out in this letter are correct and provide industry guidance confirming this.

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The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia

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