KPMG’s Corporate Regulatory Services assists you in determining and achieving investment firm exemption and identifying strategies to minimize regulatory impact on group entities.

The challenge
Following the financial crisis, G20 members met in Pittsburgh in 2009 to define new regulatory requirements for the financial markets. Under EMIR, most non-financial counterparties are classified as NFC-, proving that no clearing threshold is exceeded. The next challenge for corporates is to cope with MiFID II and potential classification as an investment firm. Such classification would result in additional capital requirements and applicability of other banking regulations.

Each corporate enterprise contracting commodity derivatives is in principle within the scope of MiFID II and will therefore be classified as an investment firm. However, exemption can be achieved if a firm proactively notifies the competent authority that its commodity derivative trading volume is not significant relative to the overall trading volume on the European market and is ancillary to its main business.

There are a number of consequences if exemption is unable to be achieved. Requirements for the firm subsequently include having to obtain an investment firm license and compliance with post- and pre-trade transparency rules, MiFID II reporting obligations and CRD IV capital requirements. Moreover, it will be classified as a financial counterparty under EMIR with clearing and margining duties. Even if the exemption can be applied, position limits for counterparties at trading venues must be respected and the effects of a modified derivative definition – with cross effects on EMIR – require analysis.

Our scope of services for corporates
The KPMG’s Corporate Regulatory Services team focuses exclusively on corporates. Our expert advice specifically targets compliance with EU regulatory requirements for corporates. With our benchmark knowledge of EU regulations we have expertise in:

- Supporting firms in implementing audit-proof processes, IT solutions and documentation to qualify for the investment firm exemption
- Providing the full picture of dependencies and cross effects between MiFID II, EMIR, MAD and REMIT
- Supporting investment firms in developing strategies to minimize the regulatory impact and costs
- Considering the derivative regulations in other jurisdictions worldwide and developing synchronised reaction strategies due to our G20+ monitoring network
- Providing assurance letters for management based on international compliance standards.
Proof of ancillary activity to be exempted
Firms with commodity derivatives are required to calculate two ratios involving the ‘market share test’ and the ‘main business test’:

Market share test
This test considers whether a firm’s speculative (non-hedging) trading activity in commodity derivatives is significant in relation to the overall trading activity in the EU market. Hedging, intragroup and regulated transactions can be deducted as ‘privileged transactions’ from a firm’s overall position. Firms must be below a threshold per commodity class that has been set for metals to 4%, oil/oil products 3%, coal 10%, gas 3%, power 6%, agriculture 4%, others incl. freight 15% and emission allowances 20%.

Main business test
This test measures a group’s speculative (non-hedging) trading activity in commodity derivatives as a percentage of its total derivatives trading activity in all commodity classes. The result of this test will influence the thresholds defined under the market share test. Depending on the results, the thresholds for the market share test may decrease to 20% of the original threshold.

Hedging exemption
Similar to EMIR, the proof of a hedging purpose for derivatives is the key factor for firms to qualify for the exemption. Under MiFID II, hedging evidence has to be available not only for OTC but also for exchange-traded (ET) derivatives. Specifically, MiFID II requires firms to have internal policies in place describing in detail the hedging and trading strategy, especially if there is no direct relationship with the underlying risk. In addition, controls and systems ensuring the identification and separate processing of non-hedging deals are required (e.g. separate portfolios, limits or other risk measures). All processes, measures and policies need to be audit proof in anticipation of authority examinations. ESMA has already announced that the use of the hedging exemption will be subject to increased scrutiny and possibly stricter limitations in the future.

KPMG project set-up
A typical project plan would include the following key steps:

1. Indicative calculation of the two tests to evaluate if eligibility for the investment firm exemption is realistic
2. Identification of the group-wide derivative portfolio (OTC and ETD) according to MiFID II
3. Aggregation of the data. The complexity of this step may vary depending on data availability due to existing EMIR requirements and the heterogeneity of the front-office systems.
4. Establishing audit-proof hedge documentation (in particular for ETD) building upon the existing internal measures and policies
5. Performing the two tests and supporting preparation of notification to the competent authority
6. Delivery of a statement confirming eligibility for the investment firm exemption
7. If eligibility does not apply: delivery of a project plan to transform the entity into a fully regulated investment firm

Positioned to serve you best
The dedicated KPMG’s Treasury – Efficient Finance Operations team has conducted assurance and implementation projects for more than 150 corporate clients throughout Europe. We are in frequent consultation with competent authorities and have benchmark and leading market practice knowledge to develop solutions and documentation.

Apart from our in-depth expertise in Corporate Regulation, our team consists of experienced Corporate Treasury and Commodity Risk Management experts.

Learn more about Finance and Treasury Management and Financial Market Regulation: kpmg.ch

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