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Summary of EC Review of the Markets in Financial Instruments Directive (Directive 2004/39/EC) ("MiFID") for Commodity Firms

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Introduction

MiFID has been in force since November 2007 and is currently under review by the European Commission (the "**EC/Commission**"). The Commission issued a consultation paper on 8 December 2010 (the "**Consultation Paper**") on possible amendments to MiFID, which will be open for comment by market participants, regulators and other stakeholders until 2 February 2011. A formal Commission proposal for reform and an impact assessment are expected in Spring 2011.

The Commission proposes significant changes, in particular to the own account specialist commodity dealer exclusions, and given the extent and significance of the changes, the time limit for responses to the Consultation Paper is very limited. Indeed, whereas it was initially suggested that the review would only result in minor tweaks to the MiFID framework, it has, in fact, resulted in a much more prescriptive and powerful instrument, which will have a particularly large impact on commodity companies. In addition, the fact that the Commission has only scheduled a short time between its receiving comments and its publishing a formal proposal implies that its current suggestions are already entrenched.

Aims of the review

MiFID is generally seen as having been successful in achieving its aims of increasing competition, enhancing the single market, increasing harmonisation and transparency, and protecting investors. The focus, above all, is on transparency which is why the commodity industry will be particularly impacted upon as this previously enjoyed very little regulatory oversight. This is a departure from the Commission's previous focus on increasing competition through the EEA.

Specifically, the proposals under consultation attempt to:

- establish a safer, more transparent, more responsible financial system in the wake of the financial crisis;
- target less regulated and 'more opaque' parts of the financial system e.g. instruments traded over the counter ("**OTC**") in accordance with the recent G20 consensus;
- target the commodities markets, due to the increased presence of financial investors arguably leading to excessive price increases, price dislocation and volatility, and due to recent concerns about integrity in EU energy and carbon markets;
- provide for rapid changes in market structure and technological development in EU equity markets e.g. the development of high frequency trading;
- strengthen investor protection; and
- contribute to the development of a 'single rulebook' for EU financial markets, by minimising the discretion Member States have under EU financial services regime.

Proposals for amendments to MiFID as regards Commodity Companies

Exempt activities to be reduced

Commodity companies currently benefit from generous specialist own account commodity dealer exemptions in MiFID, covering both hedging and speculative transactions in relation to commodity derivatives caught within MiFID. This was due to the Commission not having sufficient time to deal with commodities and in particular regulatory capital requirements for commodity dealers, when commodity derivatives were brought within the scope of MiFID. The Commission effectively "parked" the commodity issue for a later date (originally intended to be 2010 but pushed back to 2014 at the latest to coincide with the general MiFID review).

It was widely recognised and anticipated that the own account commodity dealer exemptions would be narrowed and indications as to how this would be carried out were provided by the Commission in the context of the third EU energy package of reforms. It was anticipated that the wide Article 2.1(k) exemption (which provides that a company performing commodity and/or commodity derivative trading for its own account as its main business is exempt from regulation under MiFID provided the main business of the company's group is not the provision of investment services) would be deleted; the Article 2.1(i) exemption which according to the FSA's interpretation, covers hedging transactions only and not speculative transactions, would remain and there would be a wider exclusion introduced for those dealing in hedging or speculative transactions on own account with sophisticated clients, with the meaning of "sophisticated" being unclear (e.g. would sophisticated mean sophisticated in commodities or sophisticated in commodity derivatives trading?).

The worst case scenario for unregulated commodity firms who currently rely on a combination of the Article 2.1(k), 2.1(i) and group exclusion in Article 2.1(b) of MiFID and the dealing with or through an authorised firm exclusion from FSMA (which is only available to firms falling outside of MiFID) to avoid needing to be authorised in the UK, was that Article 2.1(i) would be the only own account commodity exemption provided in MiFID.

The current proposals are as follows:

It is proposed in the Consultation Paper that Article 2.1(k) of MiFID will be deleted. The Commission states that the deletion is in accordance with the political consensus to allow exemptions to regulation only where necessary and will serve to further protect unsophisticated investors from firms which are not currently subject to conduct of business principles. Although the counter argument that commercial firms do not pose systemic risks, has not been countered. As such, this will no longer be one of the exemptions upon which commodities firms may rely upon.

In a similar vein, it is proposed that Article 2.1(i) of MiFID be amended to exclude dealing on own account with clients of the dealer's main business. This amendment will limit the application of the exemption solely to hedging physical and price risks (the current FSA interpretation). The notion of an 'ancillary activity' in the exemption will be interpreted more narrowly and it is proposed that its application be limited by both quantitative measures (e.g. the trading cannot exceed a certain percentage of the main activity) and qualitative measures (e.g. the company must not dedicate specific personnel or resources for carrying out the ancillary activity).

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The combination of the proposed amendments will all but remove the special regulatory regime previously enjoyed by commodity firms. The only permitted investment services commodity firms will be able to undertake without needing authorisation under MiFID will be limited hedging activities. This means that, if passed, many currently exempt commodity firms will be brought under the umbrella of MiFID for the first time, which will have a significant impact on their costs of doing business.

Surprisingly, nothing is mentioned in the Consultation Paper relating to the dealing on own account exemption in Article 2.1(d) of MiFID which exempts own account dealers who are neither market makers nor persons who deal on own account outside a regulated market or an MTF on an organised, frequent and systemic basis by providing a system accessible to third parties in order to engage in dealings with the. This exemption is widely criticised because it is drafted very narrowly and very little guidance is provided as to what it means. As a result, the exemption is currently rarely relied upon. If the own account specialist commodity dealing exclusions are narrowed, unregulated commodity firms will be interested in seeking to use this exemption. Responses to the proposals should include a request for the Commission to amend Article 2.1(d) so that it is usable or at least to provide additional guidance on the scope of this exemption.

The review has not provided details on capital requirements for commodities firms who will be affected by these changes as this will be addressed in a separate review. Previous advice from CESR and CEBS in 2008 concluded that the application of the Capital Requirements Directive large exposures regime to commodity firms appeared to be disproportionate and advocated a more bespoke prudential regime for commodities firms which took into account the lower systemic risk that commodities firms generally posed in the market. Whatever the outcomes of any such review, commodities firms that are caught by MiFID should be able to rely on a transitional regime that exempts them from the capital requirements of the CRD and the large exposure limits until 31st December 2014.

Definition of 'other financial instrument'

The Consultation Paper suggests removing the requirement that an instrument be cleared through a central counterparty from the list of criteria for when a C(7) commodities derivative has the characteristics of an 'other financial instrument'.

There is no exclusion proposed for transactions with sophisticated clients

As such, if a derivative meets the remaining two criteria that it is equivalent to an exchange traded contract and is standardized, it will be classed an 'other financial instrument'. ESMA will then determine which contracts are eligible for clearing under EMIR.

This change theoretically makes it more likely that a commodity derivative will trigger the test for being a financial instrument but it may not make much difference in practice if it is to be assumed that most standardised OTC derivatives will be deemed eligible for clearing in due course under the Commission's current proposed OTC reforms. It has also avoided the possibility that a derivative might not be considered a financial instrument because the party trading it was excluded from the clearing obligation, as some commercial trading firms will be.

Position reporting

The Commission is considering imposing position reporting requirements on all trading venues which admit commodities derivatives to trading. The options currently being considered include an obligation on exchanges to report the regulatory category of their end users (e.g. credit institution, insurance company, alternative investment manager etc), an obligation to report the types of derivative positions being traded by reference to the way they are accounted for under IFRS IAS 39, or a combination of the two.

This reporting requirement is one of the areas of the proposals which has generated much discussion, partially due to the fact that, as recently as a year ago, there was little discussion of it being imposed. Whereas some exchanges in London (including Euronext Liffe where agricultural commodities trade) are already moving towards position reporting, others, notably the London Metal Exchange, remain opposed to the initiative.

Emissions Allowances

The Consultation Paper states that emission allowances themselves are not classified as financial instruments under MiFID. On the other hand, derivative contracts on these allowances (and other environmental credits) are financial instruments under MiFID under the same criteria as derivatives on commodities. Although the Commission recognises that the market for emissions allowances may be a subject for supervision, it states that further study is necessary in order to determine whether this should be through their classification as financial instruments or through separate supervision. A separate consultation on this issue will be published in due course.

Standardised OTC contracts to be traded on exchanges or platforms

As part of the global effort to increase the transparency and oversight of OTC markets, and in accordance with the G20's call for all '*standardised'* OTC derivative contracts to be traded on exchanges or electronic trading platforms by 2012, the Commission is proposing that under MiFID, all derivatives which are eligible for clearing must be traded on:

— regulated markets;

— MTFs; or

— a '*to be defined*' sub category of organised trading facilities which meet certain criteria.

In accordance with EMIR proposals, the European Securities and Markets Agency ("**ESMA**") has been identified as the appropriate body to determine which derivatives are eligible for clearing based on the frequency they are traded and the average size of transactions (amongst other things).

This is in line with the approach adopted by the Commission in its Regulation on OTC derivatives, central counterparties and trade repositories on 15th September 2010 which is covered in a separate Reed Smith client alert.

Non equity instruments, including OTC derivatives

The Consultation Paper includes proposals for the extension of the MiFID pre- and post-trade transparency regime (as amended by the proposals above) to all trades, wherever executed, in specific non-equity products. Such products would include all derivatives which are eligible for clearing. This proposal goes further than CESR's technical advice, which did not include eligible derivatives in its suggestions and although may prove burdensome, is in line with the Commission's drive for transparency. Read in conjunction with the Commission's proposals to push OTC derivatives towards central clearing, the impact on the OTC markets is likely to be significant, especially for commodity companies if OTC commodity derivatives are pushed into being centrally cleared.

The requirements for pre- and post-trade transparency will be contained in implementing legislation and will depend on the underlying asset and type of financial instrument. The requirements will likely include making pre-trade quotes for OTC derivatives transactions public, and firm quotes for certain trade sizes. The legislation may also specify that quoted prices could not significantly deviate from pre-trade information available for comparable or identical instruments on RMs, MTFs or organised trading facilities, and specify the size-threshold per asset-class under which quotes would be binding.

In addition, the Commission is consulting on whether there should be a requirement for OTC derivatives transactions to be identified and flagged in post-trade transparency reports.

The aim of the reforms is to assist the market to deal with inherent information asymmetries, support fair and orderly pricing, and improve overall market efficiency and resilience. However, the Commission acknowledges that numerous parties may argue that too much transparency may have a detrimental effect on liquidity in the market.

Transaction Reporting

The Commission has identified several issues with the current transaction reporting framework, including that:

— reporting requirements tend to diverge between Member States, which adds costs for firms and limits the use of trade reports for competent authorities;

— the requirements under MiFID need to mirror the scope of the Market Abuse Directive ("**MAD**"); and

— double reporting of trades under MiFID and the recently proposed reporting requirements to trade repositories should be avoided.

As such, the Commission proposes (amongst other things) to include all commodity derivatives, regardless of how the underlying commodities are traded.

For instruments previously totally outside the scope of transaction reporting may require significant amendments to the trading architecture in those markets.

The market may consider these proposals to be a significant departure in Europe, especially given that a lack of transparency in commodities markets has not traditionally been the subject of particular concern. While some commodities exchanges in Europe are already moving towards the initiative, others remain opposed to position reporting.

Power to permanently ban activities, products or practices

In response to certain mis-selling cases, the Commission has proposed it is given the controversial power to ban outright investment services and activities related to certain financial instruments. The Commission would need to show that the products, practices or operations in question raise 'significant and sustained investor protection concerns' or threaten 'the orderly functioning and integrity of the financial markets or the stability of the financial system' before exercising its power. This suggestion is seen as one of the most significant amendments to MiFID, particularly as the equivalent power does not currently exist in the U.S.

In addition, there are proposals for national regulators to have the power to temporarily ban a product or activity by one or more firms, and that this power could be exercised in cases where they constitute a serious threat to financial stability or market confidence in the Member State.

However, commodity derivatives are unlikely to be particularly under scrutiny by the Commission, with credit default swaps and short selling likely to be products and activities that are initially under scrutiny, particularly in relation to the short-selling of, and CDSs on, GILTS from EU member states experiencing financial difficulties.

Position management

Given the increasing importance of derivatives markets, the review has also identified a case for increased powers of regulatory oversight and intervention in relation to positions in all derivatives and commodities in particular. A number of changes have been suggested, aimed at reducing systemic risk, combating disorderly trading and reducing speculative activity in commodity derivatives markets. The suggestions would:

— Provide competent authorities with increased position management powers allowing them to request parties to explain or provide documentation in relation to a derivative position and/or reduce the size of the position.

— Introduce greater coordination at EU level in the requests for explanations and relevant documentation by competent authorities to ensure a consistent approach.

— Provide for the imposition of ex-ante (i.e. hard) position limits both for derivative contracts traded on exchange and OTC to address threats or risks to market stability or delivery and settlement.

— The extent to which the new European Securities and Markets Authority will play a role in relation to these measures is not yet known, particularly with regard to whether position limits would be set at the level of ESMA or the relevant competent authority.

From a UK perspective, this approach goes some way beyond that contemplated by the FSA and HM Treasury in their joint paper in December 2009 on reforming OTC derivatives markets, which counselled caution on adopting hard position limits based on the belief that blanket position limits would not necessarily prevent manipulative behaviour or control prices, and considering the risk that OTC trading activity migrate to less transparent regulatory regimes. Although the review went further, it did not appear to propose setting outright hard position limits similar to those in the U.S., where a greater clampdown has been threatened and appears to be nearer to implementation.