ReedSmith

Replacements for MiFID and MAD – the key issues for commodity and energy traders

Author: Jacqui Hatfield, Partner, London
Author: Brett Hillis, Partner, London
Author: Melissa Peters, Associate, London

Publication Date: October 25, 2011

On Thursday 21 October, the European Commission published two sets of long anticipated legislative proposals that will have major effects on commodity and energy traders. The first proposes replacing the Markets in Financial Instruments Directive (2004/39EC) (**MiFID**) with a new directive (**MiFID II**) and a regulation (**MiFIR**). The second is a new regime for market abuse under a Market Abuse Regulation (**MAR**) that will replace the current Market Abuse Directive (2003/6/EC) (**MAD**). Both are key parts of the European Community's response to the G20 agreements to improve the regulation, functioning and transparency of financial and commodity markets.

The MiFID proposals rewrite the regulation of commodity derivatives trading in the EU. They will tighten regulation by narrowing the exemptions from financial regulation available to commodity derivatives traders, harmonising third-country access to European counterparties and customers, and establishing new position management and position limit rules.

The MAD proposals create a single EU rulebook for insider trading and market manipulation.

Both sets of proposals are likely to take a year or so to negotiate and will be the subject of lobbying by firms and trade associations. It is expected that Member States will be required to implement the bulk of MiFID II two years after its publication in the Official Journal. MAR and most of MiFIR will take effect on the same timescale but some provisions of MiFIR will take effect immediately when it is published in the Official Journal.

Firms trading in commodities and energy, as well as related derivatives, will face difficult challenges, including:

- Understanding the impact of the changes on their businesses, e.g. whether they can still access key clients and counterparties in all the instruments they need, given their current regulatory status
- Understanding the linkages between these measures and other European regulations, such as the European Market Infrastructure Regulation (**EMIR**), the Regulation on Energy Market Integrity and Transparency (**REMIT**) and developing capital adequacy regulation
- Understanding the linkages and differences between these measures and foreign measures, such as the US Dodd-Frank legislation
- Keeping up with changes to the proposals as they are subject to scrutiny and negotiation in the European institutions - as well as with the greater detail that will be provided under various European and national implementing measures
- Assessing the approaches they should take in lobbying in Europe and nationally

MiFID II - Exempt activities to be reduced

As expected, the Commission proposes deleting the commodity dealers' exemption in article 2.1(k) of MiFID. The exemption provides that a company whose main business is commodity and/or commodity derivative trading for its own account is exempt from regulation under MiFID, provided the main business of the company's group is not providing investment or banking services. The exemption is relied on by many commodities traders to stay outside of the scope of MiFID licensing when they deal in commodity derivatives.

The proposals also narrow the exemptions at articles 2.1(d) and 2.1(i) of MiFID. They will no longer apply to firms that deal on own account by executing client orders, an activity which includes dealing on a matched principal basis.

Neither MiFID nor MiFIR addresses the exemptions from capital adequacy requirements enjoyed by some MiFID-regulated commodity firms. These are currently due to fall away at the end of 2014 and it is unclear what will replace them.

MiFID II and MiFIR - Third-country access

The proposals would harmonise rules applicable to third-country firms providing services in the EU.

For a third-country firm to fall within the regime, the Commission will need to have assessed the legal and regulatory regime of the third country as equivalent to the EU regime and as giving reciprocal access to EU firms. This raises questions about the ability of third-country firms to provide investment services in the EU where they are not required to be licensed at home (e.g. in the UK through reliance on the overseas persons exclusion).

Grandfathering provisions will allow third-country firms already operating in a Member State to continue providing services and activities in accordance with the national regimes of Member States until four years after the entry into force of the new regime.

Organised Trading Facilities (OTFs)

These are a new category of regulated trading facility that will sit alongside regulated markets (traditional regulated exchanges) and multilateral trading facilities (**MTFs**). OTFs will include all forms of organised trading that bring together multiple buyers and sellers, and are not regulated markets or MTFs (e.g. broker crossing networks).

Position management and position limits

Member States will be required to ensure that regulated markets, MTFs and OTFs (together **Trading Venues**) on which commodity derivatives are traded will have to adopt position limits or alternative position management arrangements (such as position management with automatic review thresholds). The Commission will also be able to set limits itself (and determine applicable exemptions), and Member States will be restricted from imposing more stringent limits than those set by the Commission, except where this is justified and proportionate.

In addition, the European Securities and Markets Authority (**ESMA**) and national regulators will each have powers to (i) request a person to reduce his or her commodity derivatives positions, and (ii) stop a person from entering into commodity derivatives. Each power will be available even where an existing position limit has not been breached.

Obligation to trade derivatives on regulated markets, MTFs and OTFs

MiFIR gives ESMA the power to decide that a class of derivatives subject to the clearing obligation under EMIR will also be subject to a "trading obligation". Persons who are required to clear transactions in that class of derivatives under EMIR will be required to execute trades in those derivatives on a Trading Venue or a third country equivalent approved by the Commission.

For the trading obligation to take effect, ESMA will have to conclude that the class of derivatives are sufficiently liquid to be traded only on Trading Venues.

ReedSmith

Other issues dealt with by MiFID II and MiFIR

- Spot emissions allowances will be added to the list of financial instruments. But derivatives on emissions allowances will be treated as financial derivatives and not as commodity derivatives, and so will not be subject to position limits, for example.
- National regulators and ESMA will be given new powers to ban financial products and activities.
- Pre- and post-trade transparency requirements have been extended to cover spot emissions allowances and derivatives (including commodity derivatives and derivatives on emissions allowances) admitted to trading on a Trading Venue.
- Investment firms will be subject to additional transaction reporting requirements.

MAR and MAD 2

MAR will create a single, directly applicable EU rulebook for market abuse that will be broader in scope than the current requirements under MAD. This is likely to see the end of the UK's gold-plated market abuse regime.

In addition, the Commission proposes a new Market Abuse Directive (**MAD 2**). This would require Member States to put in place criminal sanctions regimes covering market manipulation and insider trading that would apply more broadly to commodities and commodity derivatives than the current UK criminal regimes. But the UK and Ireland have Treaty opt-outs which mean they can each choose whether or not to opt-in to MAD 2. MAD 2 will not apply to Denmark.

Scope of MAR regime

MAR will extend the scope of the European regulation of market abuse to cover behaviour (including trades and orders to trade) in relation to a wider range of instruments and contracts. MAR will also ban attempted insider trading and attempted market manipulation.

The primary scope of MAR has been extended to include financial instruments admitted to trading on an MTF or OTF. There are also provisions applying MAR to the auctioning of emissions allowances. MAR will apply to behaviour relating to financial instruments admitted to trading on a Trading Venue, regardless of whether the behaviour took place on the Trading Venue in question.

Insider dealing and improper disclosure of inside information

MAR contains similar provisions to MAD in relation to insider dealing and improper use of information. However, the definition of inside information for commodity derivatives has been conformed more closely with that for securities and financial derivatives.

The MAD definition required the information be subject to disclosure to the market. The MAR definition requires that the information be non-public information that, if it were made public, would have a "significant effect" on the prices of one or more commodity derivatives or related spot commodity contracts. The inside information definition is likely to be read so that non-public information will be regarded as having a sufficient effect on price if it is information that a reasonable investor would regard as relevant when deciding on the terms of a transaction in a financial instrument or spot commodity contract. This is potentially much broader than the position under MAD for commodity derivatives.

Market manipulation

Market manipulation has been broadened to cover all types of behaviour, not just entering into transactions or orders to trade. It also specifically refers to behaviour in relation to spot commodity contracts as well as financial instruments. The possibility of establishing a defence based on accepted market practice is to be removed subject to a 12-month transitional period for accepted market practices that have been previously notified.

ReedSmith

Disclosure for emissions allowance market participants

An emissions allowance market participant will be required to disclose inside information concerning emissions allowances which it holds in respect of its business. This will include information about the planned and unplanned unavailability of its installations.

About Reed Smith

Reed Smith is a global relationship law firm with more than 1,600 lawyers in 23 offices throughout the United States, Europe, Asia and the Middle East.

The information contained herein is intended to be a general guide only and not to be comprehensive, nor to provide legal advice. You should not rely on the information contained herein as if it were legal or other professional advice.

Reed Smith LLP is a limited liability partnership registered in England and Wales with registered number OC303620 and its registered office at The Broadgate Tower, 20 Primrose Street, London EC2A 2RS. Reed Smith LLP is regulated by the Solicitors Regulation Authority. Any reference to the term 'partner' in connection to Reed Smith LLP is a reference to a member of it or an employee of equivalent status.

This Client Alert was compiled up to and including October 2011.

The business carried on from offices in the United States and Germany is carried on by Reed Smith LLP of Delaware, USA; from the other offices is carried on by Reed Smith LLP of England; but in Hong Kong, the business is carried on by Reed Smith Richards Butler. A list of all Partners and employed attorneys as well as their court admissions can be inspected at the website **http://www.reedsmith.com/**.

© Reed Smith LLP 2011. All rights reserved.