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The Revised EU and US Regulatory Frameworks for Commodity Derivatives

Users of commodity derivatives markets are now facing major changes under proposed European and US legislation. Stronger supervision of the commodity derivatives market is one of the key areas of the G20 regulatory reform agenda. In Europe, the European Commission is proposing to regulate the activities of a wider range of commodity derivatives traders through amendments to MiFID. End-users will become subject to mandatory clearing requirements for OTC derivative transactions above certain thresholds once the recently agreed EMIR proposal comes into force. For the first time, the wholesale energy market and the commodity spot market will become subject to the market abuse regime. In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act brings in a comprehensive reform of the OTC derivatives market. This publication gives an overview of the impact of the various recent European and US regulatory changes from the perspective of non-financial businesses involved in commodity derivatives trading.

Introduction

Various proposals have been introduced since the onset of the financial crisis to strengthen financial regulation across the full spectrum of financial services at international, EU and domestic levels. Previous client publications address many of these proposals.[1] This publication draws together various threads of regulation in the context of their impact on commodity derivatives trading.

[1] Further information is available in our client publications, which are available from our website: Twice as MAD: Legislative Proposals to Amend the European Regulation of Market Abuse; Proposed Regulation of EU Emissions Allowances as Financial Instruments; A Changing Landscape: The MiFID II Legislative Proposal and OTC Derivatives Regulation and Extraterritoriality.

In the EU, the following regulatory initiatives are currently underway which will impact commodity trading:

- the legislative proposal[2] known as MiFID II to reform the Markets in Financial Instruments Directive ("**MiFID**"),[3] by significantly broadening the scope of regulation of commodity derivatives within the EU;
- a new regulation on OTC derivatives, known as the European Market Infrastructure Regulation ("**EMIR**"),[4] which will impose an obligation on certain parties to eligible OTC derivatives contracts to clear such contracts with a central counterparty (i.e. a clearing house), whilst imposing potentially stringent margin and capital requirements in relation to bilaterally-cleared OTC derivatives (in conjunction with a new regulatory capital regime in CRD IV);[5] and
- an enhanced market abuse regime ("**MAD II**") consisting of a new market abuse regulation ("**MAR**"), which extends the regime to spot commodity contracts[6] and a new directive ("**CSMAD**"), which requires member states to criminalise market abuse.

In the US, Title VII of Dodd-Frank amended the Commodities Exchange Act of 1936 and the Securities Exchange Act of 1934 to provide for a comprehensive regulatory regime governing the swaps market.

EU Reform of Trading: MiFID II

The Current Framework

Currently, both cash-settled and physically-settled commodity derivatives are investments subject to MiFID regulation. However, owing to the following exemptions non-financial companies generally stay outside the scope of MiFID (and hence financial regulation):[7]

- persons who only deal on own account (unless they are market makers or deal outside a regulated market or a multilateral trading facility ("**MTF**") as a systematic internaliser);[8]
- persons whose main business consists of dealing on own account in commodities and/or commodity derivatives (provided they are part of a non-financial group); [9]
- persons who deal on own account in financial instruments, or who provide investment services in commodity derivatives or in other prescribed derivative contracts to clients of their main business, provided that this is an ancillary activity of their main business.[10]

[2] Published on 20 October 2011 and available at: http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf.

[3] Directive 2004/39/EC. MiFID II consists of a new MiFID directive and a regulation on markets in financial instruments ("**MiFIR**").

[4] Available at: http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_652_en.pdf.

[5] The proposed changes to the Capital Requirements Directive include a new Capital Requirements Regulation (CRR) and the CRD IV Directive. The CRR and the CRD IV Directive will replace and recast the Capital Requirements Directive (2006/48/EC and 2006/49/EC) (CRD).

[6] Although MAR will not directly govern spot commodity markets, it will cover transactions or behaviours in spot markets which are related to and have an effect on financial and derivative markets within its scope.

[7] MiFID, Article 2(1).

[8] MiFID, Article 2(1)(d).

[9] MiFID, Article 2(1)(k).

[10] MiFID, Article 2(1)(i).

MiFID II Proposals on Commodity Derivatives

Under MiFID II, the general "dealing on own account" exemption will be modified to exclude members of or participants in regulated markets and MTFs. Many companies that currently rely on this exemption would therefore be unable to do so under the new regime. The exemption for entities whose main business is dealing on own account in commodity derivatives is proposed to be removed.

The "ancillary activity" exemption will be retained in MiFID II, albeit in a slightly modified form.[11] This exemption will be available to businesses which:

- deal on their own account in investments (but other than by executing client orders);
- provide investment services (other than dealing on own account) only to other group companies; or
- provide services other than dealing on own account in derivatives, including commodity derivatives, and emission allowances to the clients of their main business.

The key requirement for this exemption is that, in each case, all such trading must be "ancillary" to the main business of the group where the main business does not comprise investment services.[12] Such "ancillary" activity is determined by reference to "the extent to which the activity is objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity", and "the capital employed for carrying out that activity".[13] The effect of these new rules is that many non-financial businesses trading in commodity derivatives to hedge their risk, including energy firms, construction companies and manufacturers, may be forced to register trading subsidiaries as investment firms unless they can show that any trading activities are "ancillary" to their main business.

Firms that are captured by MiFID II will be subject to national authorisation, regulatory capital requirements and various organisational requirements. There will be various conduct of business obligations, including rules to handle conflicts of interest, provisions to ensure investor protection (such as best execution obligations when executing client orders) and certain pre-trade and post-trade transparency requirements. Such requirements would greatly increase the compliance costs and regulatory burden on end-users.

Trading in emissions allowances will also be more closely regulated under MiFID II. This is discussed in detail in a separate dedicated publication.[14]

Venue Trading

There is a proposed new requirement that sufficiently liquid standardised derivatives must be traded on organised trading venues,[15] such as regulated markets and MTFs but also including the new proposed category of "organised trading facilities" or OTFs (which can be an electronic trading platform). The Commission and ESMA will define the list

[11] MiFID II, Article 2(1)(i).

[12] It is not entirely clear from the text of the MiFID II proposal whether the additional requirements of Article 2(1)(i) must be met for commodity derivatives traders to rely on the intra-group exemption in Article 2(1)(c).

[13] MiFID II, Article 2(3).

[14] The publication is available from our website: Proposed Regulation of EU Emissions Allowances as Financial Instruments.

[15] The new requirements for trading venues are set out in MiFID II, Articles 27, 59 and 60.

of derivatives subject to the trading obligation through technical standards (which are expected to be aligned with the test for derivatives subject to the EMIR clearing obligation). The scope for bespoke "pure" OTC transactions is therefore significantly narrowed, with additional collateral costs arising for end-users of both the cleared and non-cleared markets, albeit this may be offset to a degree by the enhanced liquidity resulting from standardised trades taking place on an organised market.

Position Limits

Currently, position limits are generally handled by exchanges and clearing houses in Europe as a self-regulatory or risk management function.

MiFID II will impose the following new requirements:

- all trading venues on which commodity derivative contracts are traded will have to impose position limits or adopt alternative arrangements to ensure the orderly functioning of the market and of settlement conditions for physically delivered contracts; and
- commodity derivatives trading venues will have to publish a weekly report providing details of aggregate positions which are held by the different categories of traders, including the clients of those not trading on their own behalf, and make this available to the relevant national authority upon request.[16]

Energy market participants have expressed concerns that such limits will dampen market responsiveness and impair effective risk management through hedging.

In "exceptional" cases, where it is "objectively justified and proportionate", national regulators and the European Securities and Markets Authority ("**ESMA**") are proposed to be given the power to impose limits on firms' commodities positions. Under MiFID II, national authorities would also have the explicit power, if they consider it "necessary for the exercise of their functions", to demand information from any person regarding the size or purpose of a position in commodity derivatives contracts and to require a reduction of the position.[17] ESMA will be given pan-European powers to demand that any person reduce the size of its derivative position, which adds a further overlay of potential regulatory intervention to the commodity derivatives markets.

There is little detail at this stage as to the criteria that national regulators will apply in determining whether to impose such limits, but the above powers are likely to cause concern for commodity traders, who will be looking for clear rules as to when regulators may impose any position limits or take steps to intervene. The Commission may adopt delegated acts setting out harmonised position limits across the EU.

EU Reform of Clearing: EMIR

The final compromise text of EMIR was published by the Danish Presidency of the Council of the EU on 19 March 2012 and is expected to be published in the Official Journal in due course.

[16] MiFID II, Articles 59 and 60 set out the position limits and reporting requirements.

[17] MiFID II, Articles 71(2)(i) and 72(1)(f).

EMIR will require that[18]:

- trades involving financial counterparties (e.g. banks and investment firms) and also non-financial counterparties (broadly speaking, all non-financial services entities), to the extent that relevant thresholds in OTC derivatives transactions over a pre-defined period are exceeded (the "**clearing threshold**"), have to be centrally cleared.[19] Trades which are "*objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity*" will not count towards the clearing threshold of the entity or its group. Once the clearing threshold is met, any OTC derivatives transactions entered into during a three-month period will have to be cleared. Intra-group transactions will not be subject to a clearing obligation.
- there be a reporting obligation for "*any derivative contract*" entered into before and outstanding on the date of EMIR's entry into force, or entered into after EMIR enters force. Financial and non-financial counterparties and CCPs will be required to report the entering into of OTC derivative contracts to a trade repository. This reporting obligation will apply irrespective of the whether any thresholds are exceeded, but may be delegated to a third party. Various operators are currently developing repositories for derivatives.
- for OTC derivatives not subject to central clearing, both financial and non-financial counterparties that enter into such derivatives have procedures in place to measure, monitor and mitigate operational and credit risk, including at least the timely confirmation of the terms of the contract (if possible by electronic means) and portfolio reconciliation, monitoring and dispute resolution processes. Daily marking to market will also be mandatory for such contracts, with risk management procedures in place to require the timely, accurate and appropriately segregated exchange of collateral.[20]

EMIR is expected to be formally adopted soon, given the Commission's commitment to meeting the G20 deadline of reforming the OTC derivatives markets by the end of 2012.

EU Reform of Market Behaviour

Abusive Squeezes and MAD II

One area targeted by the new market abuse regime is cross-market manipulation or the use of an abusive squeeze. Under the current EU regulatory structure, there are no express provisions preventing a person from accumulating physical assets to create a shortage in the physical market, entering into a futures contract in relation to those assets and then requiring physical delivery of the stock-piled assets to satisfy the derivative contract. This practice, which artificially

[18] EMIR applies to transactions between non-EU entities and EU entities where the non-EU entity would be subject to EMIR if they were incorporated in the EU. Transactions wholly between non-EU entities are also caught where the contract has a direct, substantial and foreseeable effect within the EU or where necessary or appropriate as an anti-evasion measure: EMIR, Article 3.

[19] The derivatives subject to the clearing obligation, as well as the applicable clearing thresholds, will be set out in technical standards – eligibility for clearing of derivative contracts will be determined by reference to the risk in the financial system, the liquidity of contracts, the availability of pricing information, the ability of the CCP to handle the volume of contracts and the level of client protection provided by the clearing house.

[20] EMIR, Article 8(1).

affects the price of the commodity derivative market without being caught by the existing directive,[21] is already unlawful in some member states[22] but will be prohibited under MAR as cross-market market abuse.[23]

Wholesale Energy Products

The EU has adopted a Regulation on Energy Market Integrity and Transparency ("**REMIT**") specifically to regulate the wholesale energy markets.[24] REMIT came into force on 28 December 2011.

REMIT prohibitions apply to energy market participants, which include persons trading wholesale energy products, whether OTC or on a power exchange. REMIT also applies to transactions in derivatives and supply and transportation contracts relating to electricity and gas whether financially or physically settled.[25] REMIT prohibits insider trading and market manipulation in the spot market, but does not apply to energy derivatives (to which the general market abuse regime applies). Furthermore, transaction reporting obligations will not apply to participants who have reported transactions in accordance with MiFID or EMIR.

REMIT introduces:

- an express prohibition on the use of inside information when buying or selling in the wholesale energy markets, so that all exclusive and price sensitive information must be disclosed before any trades can take place; and
- a prohibition against the manipulation of wholesale energy product transactions or the dissemination of any false or incorrect information which gives misleading indications as to price, supply or demand.

All market participants subject to REMIT will be required to:

- introduce and review information barriers between operational and trading activities in order to ensure timely public disclosure of all relevant information;[26]
- publish inside (i.e. confidential, price-sensitive) information relating to wholesale energy products in an effective and timely manner;[27]
- monitor and notify potential breaches of market abuse provisions;[28]
- submit details of energy transactions to the Agency for the Cooperation of Energy Regulators ("**ACER**"),[29] with a record of any transactions in wholesale energy products;[30] and

[21] MAD, Article 2 renders illegal only the distortion of the price of financial instruments, rather than derivatives trading which distorts the prices of physical markets.

[22] E.g. the UK – the FSA's Business Standards "MAR 1 : The Code of Market Conduct" paragraph 1.6.11

[23] MAR, Article 8(1).

[24] Regulation (EU) 1277/2011

[25] REMIT, Article 1 sets out the contracts subject to its provisions.

[26] REMIT, Article 4.

[27] REMIT, Article 4.

[28] REMIT, Article 15.

[29] Details are available from: http://www.acer.europa.eu/portal/page/portal/ACER_HOME.

[30] REMIT, Article 8.

- register with the National Regulatory Authority ("**NRA**") of the country where they are registered or active, after which they will be required to report transactions to that NRA. Market participants may have to establish new reporting mechanisms in order to comply with this requirement.[31]

Changes to the US Regulatory Framework

The Future Treatment of Commodity Derivatives in the US

When fully implemented, Dodd-Frank will:

- require the registration and regulation of swap dealers and major swap participants ("**Swap Entities**");
- impose clearing and trading requirements for market participants for standardised derivative products (with only limited exceptions for commercial end-users engaging in hedging activity);
- create a robust reporting regime for the reporting of swap data to central data repositories and for real-time price reporting by such repositories; and
- permit the US Commodity Futures Trading Commission ("**CFTC**") to adopt new position limits applicable to swaps as well as futures.

As discussed in more detail below, commodity swaps and options subject to the Dodd-Frank requirements will generally fall under the regulatory jurisdiction of the CFTC. Dodd-Frank does not fundamentally change the existing regulatory regime applicable to futures and options on futures, which will continue to be regulated by the CFTC under the Commodity Exchange Act and CFTC regulations.

The requirements of Title VII of Dodd-Frank can broadly be categorised into requirements that will apply to market participants generally and those that will only be applicable to Swap Entities:

- general requirements applicable to all market participants include, among others, the price reporting requirement, the mandatory clearing and trading requirements (subject to the end-user exception), and compliance with newly established position limits applicable to swaps; and
- registered Swap Entities will also be subject to, among other things, internal and external business conduct standards, margin and capital requirements, and other risk management and record-keeping requirements.

Overview of Certain Proposed and Final Rules Relevant for Commodity Derivative End-Users

Most of the requirements of Dodd-Frank's new regulatory framework for swaps will be determined through regulations currently being adopted by the CFTC. While several regulations have been finalised, a number of key regulations, including those providing definitions of terms such as swap, swap dealer and major swap participant, have yet to be completed. As a result, the CFTC has provided temporary relief from complying with most of the Title VII requirements until the earlier of (i) the effective date of the final rules and (ii) 16 July 2012. A brief overview of recently proposed and final rules applicable to end-users of commodity derivatives is set out below.

[31] REMIT, Article 9.

Products Covered by New Requirements

Commodity derivatives will constitute "swaps" under Dodd-Frank. However, according to CFTC-SEC guidance, the proposed definition of "swap" would not include physically settled forward contracts on non-financial commodities, provided that the parties intend to settle the transaction by physical delivery. In addition, for market participants that regularly make or take delivery of non-financial commodities in the ordinary course of their business, a "book-out" transaction (a forward contract where the parties enter into individually negotiated cancellation agreements instead of making or accepting multiple off-setting deliveries of the underlying commodity) would qualify for the forward exclusion from the swap definition, provided the book-out transaction is made by way of a subsequent, separately negotiated agreement.

Swap Dealer Definition

Under proposed CFTC rules expected to be adopted in the next few weeks, a person would generally be a swap dealer if: (i) it holds itself out as a swap dealer; (ii) makes markets in swaps; (iii) regularly enters into swaps with counterparties for its own account; or (iv) engages in activities causing it to be known as a dealer or market-maker in swaps. A person who engages in swap activities for its own account where this is not part of its regular business will not be a swap dealer. Some energy companies have expressed concern at this definition, given that they operate large energy trading operations, which could potentially become subject to additional regulation.

Margin Requirements for Uncleared Swaps

The CFTC and banking regulators have proposed rules that will generally require Swap Entities to collect initial and variation margin from certain types of counterparties in connection with their uncleared swap transactions. For swaps with non-financial end-users, the CFTC proposes that the parties should determine by agreement whether and the extent to which they would be required to provide initial and variation margin. The banking regulators' proposal, on the other hand, would require Swap Entities that are banks to determine a credit exposure limit for a non-financial end-user and collect initial and variation margin to the extent that such end-user's credit exposure exceeds the calculated limit.

Final Rules on Position Limits

The CFTC has adopted final rules on position limits applicable to option, futures, swap and swaption contracts related to 28 agricultural, metal and energy commodity contracts. The rules represent a significant shift in approach, as the CFTC will take over responsibility for these position limits from the exchanges, expand position limits to include swap contracts, and expand aggregation requirements.

The final rules on position limits have caused some controversy among market participants. ISDA and SIFMA have recently filed lawsuits in US federal court, challenging (amongst other issues) the CFTC's alleged failure to make findings as to the necessity and appropriateness of the position limits prior to adopting the final rules, as required by Dodd-Frank, and to conduct a meaningful cost-benefit analysis. ISDA and SIFMA have recently filed a motion with the court requesting that enforcement of the new position limits be stayed pending resolution of the litigation.

Reporting of Commodity Swaps

The CFTC has recently adopted two final rules to implement the real-time price and swap data reporting requirements of Title VII. The rules require market participants to report a wide range of swap information upon execution or shortly thereafter to a swap data repository which is then responsible for making certain information available to the public.

Updated and other lifecycle information for a given swap must be reported to the same repository throughout the life of the swap.

The CFTC has elected to phase in implementation of the requirements under the final rules based on product type and reporting party status. The dates of compliance will be no earlier than 16 July 2012 when Swap Entities, swap execution facilities, designated contact markets and derivatives clearing organisations will be required to start reporting swap transaction data with respect to interest rate and credit default swaps. Reporting by Swap Entities on commodity swaps will commence 90 days later. A further 90 days after the second compliance date, reporting by all remaining swap market participants (including end-users) will begin with respect to commodity swaps.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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