

MEMORANDUM

Discussion draft: 19 July 2006

International Swaps and Derivatives Association

Commodity Derivatives Working Group - MiFID commodity exemptions review

We outline below, for the purposes of discussion within the Commodity Derivatives Working Group, an outline of a three step analysis for discussion with the Commission in relation to the review of the exemptions for commodities business contemplated by Article 65(3) of Markets in Financial Instruments Directive (MiFID).

- Step 1: Request Commission to undertake cost benefit analysis and to identify the case, if any, for imposing financial regulation on specialist commodity firms.
- Step 2: Advocate that, if the Commission is unable to establish a case for licensing, the Commission should propose amendments to retain and make mandatory the MiFID exemption for specialist commodity firms. We discuss two options here:
 - Option 2A, which proposes an exemption for specialist commodity firms based on article 2.1(k) MiFID; and
 - Option 2B, which modifies option 2A to address some of the potential issues that it raises e.g. to address the issue of specialist commodity firms that deal with retail investors.
- Step 3: Advocate that, if step 2 is not acceptable, the Commission should propose a harmonised light-touch regulatory regime for specialist commodity firms (defined in the manner described in option 2B). This light touch regime should incorporate the changes to regulatory capital/large exposure regime being developed by the CFRC working group for specialist commodity firms. However, it should also include modifications to other elements of the MiFID regime as it applies to these firms, where the requirements would be disproportionate. In addition, the existing MiFID exemptions would need to remain in place till 2013, to address transitional issues.

We also discuss a number of other supplementary issues that arise whichever approach is adopted and list some options which have been discarded.

This paper does not discuss the policy options for the regulatory capital regime being developed by the CFRC working group.

Step 1: Cost benefit analysis and case for regulation

- Burden of proof should be on the Commission to justify the case for imposing financial services regulation on specialist commodity firms
- Requires a review of the market, the regulatory risks and a cost benefit analysis

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- Similar arguments to those set out in the CFRC letter to the Commission, plus additional arguments to address other elements of the regime, such as the argument that licensing is needed to deter fraud
- Also argue for need for a harmonised approach for the sector, as to which entities are within the scope of authorisation requirements.
- Focus should be on the need for the licensing of specialist commodity firms: it is assumed that competent authorities would retain the MiFID powers to supervise regulated markets and MTFs and that the market abuse regime would continue to apply to commodities business

Step 2: No licensing requirements for specialist commodity firms

- Advocate that, if the case for licensing cannot be made out, the Commission should propose amendments to retain and make mandatory the existing MiFID exemption for specialist commodity firms.

OPTION 2A:

- Retain exemption in Article 2.1(k) in current form but require member states to implement the exemption e.g. by replacing that provision with a new article 3A (mandatory exemptions):

"Member states shall not impose requirements under this Directive on persons whose main business consists of dealing on own account in commodities and/or commodity derivatives provided that they are not part of a group the main business of which is the provision of other investment services within the meaning of this Directive or banking services under Directive 2000/12/EC."

- Issues:
 - Regulators may be concerned that exempt firms could provide investment services or activities to retail clients without being licensed at all.
 - Does not cover firms whose main business includes dealing in instruments covered by Annex 1, Section C10 e.g. weather derivatives (compare current article 2.1(i)).
 - The proviso excluding entities within an investment firm or banking group gives rise to un-level playing field for such entities (e.g. potentially prejudices non-EU booking vehicles within investment firm/banking groups).
 - Does not assist those specialist commodity firms that provide investment services/ investment activities other than dealing for own account, e.g. brokers and advisers.
 - Does not resolve whether it is necessary to retain the exemption in the second limb of article 2.1(i).¹

¹ Article 2.1(i) has two limbs: (i) an exemption for persons dealing on own account in financial instruments provided that this is an activity ancillary to their group's main business and (ii) an exemption for persons providing investment services in commodity derivatives or derivative contracts included in Annex 1, Section C10 to the

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- o Difficult for firms to structure their business to fall within or outside the exemption.

OPTION 2B:

- Modify the approach set out in option 2A to address the issues outlined above e.g. by replacing article 2.1(k) with a new article 3A (mandatory exemptions) as follows:

"Member states shall not impose requirements under this Directive on persons [(other than operators of an MTF)] who do not provide any investment services or activities other than:

(i) investment services or activities relating to the financial instruments set out in points 5, 6, 7, 9 and 10 of Annex I, Section C provided that they do not provide such investment services or undertake such investment activities for, or on behalf of, retail clients; and

(ii) dealing on own account in other financial instruments as an ancillary activity to their main business."

- Notes:
 - o This wording addresses all the issues outlined above with respect to option 2A (but it would be possible to devise variants that address some only of the issues). If a firm wishes to "opt into" regulation, it should be possible to add a business category which is not part of the firm's main business.
 - o The proviso restricting dealings with retail clients is modelled on the proviso in article 45.1(b) of the recast Capital Adequacy Directive (CAD),² which deals with the transitional exemption from large exposures. The proposal suggests that the boundary should be retail clients (as defined in MiFID). This is preferable to restricting the exemption to those that deal with eligible counterparties because of the host state control of classification under article 24. However, one objection may be that there would be no supervision of the way in which an exempt firm classifies its clients. In addition, there is a risk that a significant number of existing counterparties would qualify as retail investors (see below).
 - o The reference to "main business" in para (ii) is assessed at entity level rather than on a group basis.
 - o Under this proposal, it would probably be unnecessary to retain the second limb of article 2.1(i).
 - o The wording in square brackets addresses the additional concern that regulators may have to ensure that operators of MTFs in commodity derivatives and developing products are subject to licensing requirements even if the users of the MTF are professional clients.

clients of their group's main business, as an ancillary activity to that business. However, neither limb of the exemption is available to firms in a group whose main business is investment services or banking services.

² Numbering of CAD articles is as set out in the version published in the Official Journal on 30 June 2006.

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- General issues with respect to both options 2A and 2B:
 - There is a risk that the Commission will not even be willing to discuss this option.
 - The prohibition on member states imposing "requirements under this Directive" is intended to capture the licensing and operating requirements in Title II of MiFID.
 - There may be entities that wish to be regulated because regulation provides assurance to third parties. In other cases, the absence of regulation may have legal or regulatory consequences e.g. in relation to netting, some third country regulatory schemes (such as Australia) or (even within the EU) if firms need "top up" licences for any reason. However, it may be difficult to persuade the Commission that exempt firms should be able to opt into regulation.
 - Exempt firms would not have a passport to do business in other EU member states. However, the mandatory exemptions should protect them from licensing requirements in a similar way to the passport (compare article 3.2 MiFID). However, firms benefiting from the exemption would be exposed if member states chose to impose licensing requirements on a broader range of activities while limiting the exemption to MiFID regulated activities.

Step 3: Light touch regulation for specialist commodity firms

- Introduction of an appropriate and proportionate light touch regime which provides for the disapplication or less stringent application of aspects of MiFID in relation to a further category of investment firms: "specialist commodity firms".
- Proposal: to define "specialist commodity firms" that benefit from this regime in line with the definition in option 2B above. (As noted above, the wording of option 2B draws on wording in article 45 CAD). However, the exemption could be expanded so as to be available to operators of MTFs that otherwise meet the requirements of the definition.
- This light touch regime should incorporate the changes to regulatory capital/large exposure regime being developed by the CFRC for specialist commodity firms.
- Implementation: Deletion of article 2.1(k) and second limb of article 2.1(i) MiFID.
- Issues:
 - Will member states agree to grant a passport to specialist commodity firms if they are completely exempt from regulatory capital/large exposure requirements under the CAD? Currently, firms exempted from capital requirements under article 48 CAD still benefit from the passport but this may be an oversight rather than a deliberate policy choice.
 - The existing MiFID exemptions would need to remain in place till 2013,³ to address transitional issues. If the Commission proposes amendments in a report in April 2008, then it is unlikely that an amending directive would be adopted before 2010.

³ The existing CAD exemptions expire on 31 December 2010 and may also need to be extended.

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Member states would then need time to transpose the amendments and firms would need time to adapt to the new regime.

- Is it appropriate to reduce the burden of other aspects of the MiFID/CAD regime for specialist commodity firms?
 - o Authorisation conditions: persons who effectively direct business (article 9 MiFID) and controllers (article 10 MiFID). Comment: difficult to argue against these if there is a case for licensing to deter fraud.
 - o Membership of investor compensation scheme (article 11 MiFID). Comment: May not be significant as few counterparties eligible for protection.
 - o Organisational requirements, including systems and controls, BCP, outsourcing, record keeping, client asset rules (article 13 MiFID). Comment: Argue that, if the case for imposing licensing requirements is solely based on deterring fraud, there is no need to impose these prudential requirements.
 - o Conflicts of interest (article 18 MiFID). Comment: Argue that, if the case for imposing licensing requirements is based solely on deterring fraud, there is no need to impose these requirements.
 - o Client classification (Annex II and article 24 MiFID). See below.
 - o Conduct of business rules, best execution rules, order handling rules (articles 19, 21, 22.1 MiFID). These do not apply to business with eligible counterparties and article 19 has reduced application in relation to business with professional clients. Comment: Argue that, if the case for imposing licensing requirements is based solely on deterring fraud, there is no need to impose these requirements. Propose instead a simplified set of high level principles.
 - o General duty to act in a manner which promotes market integrity and transaction record keeping (articles 25.1 and 25.2 MiFID). Difficult to argue against the imposition of these requirements in the interests of market supervision.
 - o Transaction reporting of transactions in financial instruments admitted to trading on a regulated market (article 25.3 to 25.5 MiFID). Argue for disapplication, as regulated market will have transaction trail for commodity derivatives traded on a regulated market.
 - o Requirements for MTF operators (articles 14 and 26 MiFID).
 - o Application of anti-money laundering requirements.

Supplementary issues

- The amendments highlight the issues with respect to the client classification regime, as many existing counterparties may have to be classified as retail clients (and firms would not benefit from the proposed changes if they deal with retail clients). Propose changes to the client classification to broaden the category of professional client by including entities listed

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on regulated or equivalent markets (and their subsidiaries) and entities which are part of a group which meets the size tests on a group basis.

- There is a risk that member states may impose licensing requirements on business in instruments not covered by MiFID, e.g. physically settled OTC transactions not within section C7 Annex I MiFID. The fact that the scope of section C7 is defined by an EU regulation does not limit the ability of member states to impose licensing requirements on other categories of contract. Superequivalent licensing requirements undermine the value of step 2. Consider whether it is likely to be feasible to require member states not to impose authorisation requirements on firms which provide investment services or activities in relation to derivative or other contracts not covered by section C Annex I MiFID? Alternatively, under step 3, ISDA might argue for an extension of Section B7 to include "any derivative contract not listed in Section C".
- Is there a need further to restrict (or redefine) the scope of section C Annex I MiFID, in particular by further restricting the scope of section C7 in relation to physically settled OTC transactions? The implementing regulation already very narrowly defines the scope of section C7, limiting it to transactions traded on, expressly stated to be traded on or subject to the rules of or expressly stated to be equivalent to a contract traded on a regulated market, MTF or equivalent third country facility. Would further narrowing of the definition increase the possibility of super-equivalent licensing requirements?
- The MiFID commodity review contemplated by Article 65(3)(a) of MiFID in relation to Article 2.1(k) only contemplates a review of the exemption for firms whose main business is dealing on own account in commodity derivatives. It does not contemplate a review of the exemption for firms whose main business is dealing on own account in commodities. Does that make any difference to the approach?
- It seems clear that it is necessary to retain article 2.1(i) first limb as there will be group holding companies that need to rely on the ancillary business test. However, it may need to be considered whether this residual exemption should focus on ancillary activities on a group or individual entity basis.

Approaches discarded

The following options were discarded in preparing this paper:

- Preserving the status quo under MiFID/recast CAD.
- Introducing a (mandatory) exemption for persons who deal "with or through" an authorised firm.
- Introducing a (mandatory) exemption based on article 2.1(l) existing ISD.