

Commodity Firms in the EU:

The Case for a Differentiated Treatment under the Capital Requirements Directive

Introduction

Defined terms:

- CRD: Capital Requirements Directive
- CAD: Capital Adequacy Directive
- BCD: Banking Consolidation Directive
- FGD: Financial Groups Directive
- ISD: Investment Services Directive
- MiFID: Markets in Financial Instruments Directive
- MTFs: Multilateral Trading Facility

I. Scope

1. Current position

Currently, commodities business largely falls outside the framework of EU financial services regulation:

- The ISD (and BCD) require member states to impose authorisation requirements on firms carrying on certain kinds of financial services business. However, these do not include the businesses of trading in commodities or commodity derivatives. Nevertheless, Member States are free to impose authorisation requirements on commodity-related business and a number of Member States in fact do require firms to obtain authorisation to engage in commodity derivatives or other commodity-related business.
- Correspondingly, EU firms carrying on commodity-related businesses do not benefit from the EU "passport" for that business, even if they qualify as a credit institution or investment firm under the BCD or ISD as a result of their other activities or are subject to a national authorisation regime. If they do business cross-border, or seek to establish branches in other Member States, they may be required to obtain additional local licences where these are required. Nevertheless, some Member States (such as Italy and the UK) provide a means under which firms authorised in another Member State to conduct this business can obtain "top up" authorisation to conduct business locally.
- Similarly, entities carrying on these activities largely fall outside the scope of EU consolidated supervision requirements even if they were part of a wider group that included

banks or investment firms. Entities carrying on commodities business are not "financial institutions" which must be included within the scope of consolidated supervision under the BCD, CAD or FGD. On the other hand, where a credit institution or investment firm (or a financial institution included within the scope of consolidated supervision) carries on commodity-related business, the positions and exposures generated as a result of that business give rise to capital requirements under the BCD or CAD.

The current regime has given rise to a number of difficulties:

- Firms that are subject to national authorisation requirements, whether as a credit institution or investment firm or under a national supervisory regime, may encounter licensing barriers to cross-border business within the EU, even in wholesale markets and even though they may comply fully with a regulatory capital (and conduct of business) regime.
- Similar issues affect unregulated EU firms and third country firms seeking to do business in EU markets. They encounter the same patchwork of national authorisation regimes, creating at best uncertainty and at worst genuine barriers to cross-border wholesale business activity.
- The fact that commodity derivatives and related instruments are not financial instruments within the scope of some national regulatory regimes has given rise to uncertainties as to the applicability of some laws recognising the enforceability of close-out netting.

[To add: discussion of position of exchanges]

2. **The new MiFID definition of "investment firm"**

In the lead up to MiFID, a number of industry associations made representations arguing that the appropriate response to the difficulties presented by the current regime was to exclude wholesale commodity-related business from the scope of national financial services authorisation requirements. This would not have precluded the adoption of an EU framework for the regulation of markets and exchanges, or for the regulation of market abuse. However, it would have created the basis for a more proportionate regulatory response to the issues presented by commodity-related business.

Instead, the Commission's proposal, and the eventual directive, took a very different approach. MiFID extends the definition of "financial instrument" in the former ISD to cover, among other things:

- Cash settled commodity derivatives (section C5 of Annex I MiFID).
- Commodity derivatives traded on a regulated market (i.e. exchange) or multilateral trading facility ("MTF") (section C6 of Annex I);
- Certain over-the-counter physically settled commodity derivatives, not being for commercial purposes, to be further defined in a European Commission "level 2" implementing measure (section C7 of Annex I). The European Commission's latest proposal would limit these to:
 - [Commodity derivatives traded on third country markets and trading facilities equivalent to regulated markets and MTFs;

- The customer leg of contracts traded on regulated markets or MTFs or equivalent third country markets and facilities and certain "look alike" contracts, if cleared by a clearing house or subject to margining arrangements.]
- Certain derivatives relating to specified other underlying subject matters, such as cash settled derivatives on climatic variables, freight rates, emissions allowances or official economic statistics as well as certain physically settled transactions on other products to be defined by European Commission implementing measures (section C10 of Annex I). The European Commission's latest draft proposal would limit these to:
 - [Cash settled derivatives on a range of underlyings;
 - Derivatives on those underlyings where traded on regulated markets, MTFs and equivalent third country markets and facilities;
 - The customer leg of contracts on those underlyings traded on regulated markets or MTFs or equivalent third country markets and facilities and certain "look alike" contracts, if cleared by a clearing house or subject to margining arrangements.

The result is that anyone in the EU providing specified services and activities in relation to these financial instruments on a professional basis will be an "investment firm" requiring authorisation in the same way as a firm providing those services or activities in relation to securities or financial derivatives, unless an exemption applies. The specified services and activities are:

- Receiving and transmitting orders, execution of orders and dealing for own account.
- Portfolio management and investment advice.
- Underwriting and placing.
- Operation of multilateral trading facilities.

However, in return, such a firm obtains the EU passport, including for certain ancillary activities, which have been extended to cover investment services and activities relating to the underlying of any derivative within one the new categories of commodity and other derivatives, where those activities are connected to the provision of investment or ancillary services (section B7 of Annex I).

But as we will see, there is a price to be paid for this. The effect of being an investment firm is potentially at least to sweep firms into the regulatory capital regime in the CRD, although the immediate threat has been removed, for many firms, by the amendments made at the last minute to the CRD, providing a transitional provision for certain commodity firms until 2010.

[To add: discussion of investment advice]

3. **The MiFID exemptions**

However, MiFID also sets out a number of exemptions. Firms falling within these exemptions are not subject to the requirements of MiFID (or for the time being the CRD) and do not obtain the benefit of the EU passport. On the other hand, because they fall outside the scope of the

ISD, Member States remain free to devise and implement their own national authorisation and supervision regime and to apply it to such firms, subject only to the general constraints imposed by the Treaty.

The exemptions are complex (see text box). However, they assume an even greater importance in MiFID than their predecessors in the ISD. In the past, it was broadly accepted that a firm was not an investment firm as a result of its own account dealing activities unless it dealt on own account on a professional basis as a service to third parties. Under the new definition of investment firm, any entity which deals on own account on a professional basis is in principle subject to the directive (unless an exemption applies), even if its only dealings are as a customer of the market rather than as an intermediary. Thus, it seems that ordinary commercial companies that are end users of financial or commodity markets will now be "investment firms" unless they can bring themselves within an exemption.

[Text box: setting out articles 2(1)(b), (d), (i), (j), (k), (l).]

4. **The CRD**

Investment firms and credit institutions covered by MiFID are, in principle, subject to the full requirements of the CRD. There are only limited exemptions. Competent authorities can relax the requirements of the directive for investment firms (but not credit institutions) which are "limited licence" or "limited activity" firms, categories designed to cover a range of investment firms which are either not authorised to engage in principal dealing or who only engage it to a limited extent to meet client servicing requirements (or as a "local").

Similarly, it seems that the scope of consolidated supervision for EU investment firms will extend to other related (EU or non-EU) investment firms, including those carrying on commodity-related business. On the other hand, it seems that no similar adjustment is made for banking groups and it appears that entities carrying on commodity-related business will still not be "financial institutions", subject to the consolidation requirements of the BCD and FGD.

However, the key last minute change to the CRD was the introduction of a new transitional arrangement, which includes provision completely to exempt from the CRD:

"investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the financial instruments set out in Annex I section C points 5, 6, 7, 9 and 10 of [MiFID] and to whom [ISD] did not apply on 31 December 2006."

This exemption is available until 31 December 2010 or the date of coming into force of any modifications made pursuant to the review process envisaged by the MiFID and the CRD.

4. **The review process**

MiFID itself envisages its own review. The Commission is obliged to report to the European Parliament and the Council by 30 October 2007 on:

- the continued appropriateness of the exemption in article 2(1)(k) for undertakings whose main business is dealing on own account in commodity derivatives (but not those whose main business is dealing in commodities);

- the content and form of proportionate requirements for the authorisation of and supervision of such undertakings; and
- the continued appropriateness of the exemption in article 2(1)(i).

The amendments made to the CRD extend this review to cover:

- an appropriate regime for the prudential supervision of investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the commodity derivatives or derivatives contracts set out in Annex I Section C points 5, 6, 7, 9 and 10 of MiFID;and
- the desirability of amending MiFID to create a further category of investment firm whose main business consists exclusively of the provision of investment services or activities in relation to the financial instruments set out in Annex I Section C points 5, 6, 7, 9 and 10 of MiFID relating to energy supplies (including electricity, coal, gas and oil).

These reports may lead to the Commission proposing further amendments to the directives, so it is unlikely that changes will take effect before 2009.

5. **Potential impact of MiFID and the CRD**

It is difficult fully to assess the potential impact of MiFID and the CRD, even in the short term, because of the difficulties of interpreting some of the exemptions. In the longer term, it is also difficult to predict the outcome of the review process, which will not necessarily be limited in the way contemplated by the directives.

In the short term, the key impact will be the extension of the passport for commodity-related business to credit institutions and investment firms, who already qualify as such because of their other business, and to specialist commodity trading entities within banking or investment firm groups (who are unlikely to fall within any exemptions except possibly article 2(1)(d) or (l)). This will help those firms address the barriers presented by national authorisation requirements.

However, these firms will still have issues to address, in particular because it is likely that some Member States will continue to regulate a range of physically settled commodity derivatives falling outside the scope of the relatively narrow proposed Commission implementation of section C7. Credit institutions or investment firms conducting cross-border business with counterparties in such a country may need to obtain a "top up" licence, if one is available under local law, although to a limited extent the ancillary activity in Section B7 of Annex I may be of assistance.

Other EU and non-EU firms whose business falls within an exemption will face similar issues to the extent that they are subject to "superequivalent" authorisation requirements in their own country or wish to trade cross-border with counterparties in countries which have chosen to extend the national authorisation requirements to cover business falling within an exemption. The increased scope of national authorisation requirements triggered by the directive is likely to be a source of friction for these firms. Within the EU the firms most likely to be affected are:

- Nationally regulated commodity trading entities that fall within an exemption, most likely article 2(1)(k) because their main business is dealing on own account in commodities or commodity derivatives and who are not in a banking or investment firm group.
- Unregulated commodity producers, manufacturers, generators, etc. who will fall within one or other of the exemptions cited above.

In addition, there could be firms which lose the benefit of their ISD passport under MiFID because they will now fall within an exemption under MiFID when formerly their business included sufficient "financial" derivatives or other business to qualify for a passport.

[More on scope of exemptions]

Article	Text	Key uncertainties
2(1)(b)		<p>Can this exemption be combined with other exemptions where an entity, such as a group holding company, provides investment services (such as advice, etc.) to its subsidiaries but also engages in investment activities, such as dealing on own account in financial instruments for hedging purposes in a manner that can be regarded as ancillary to the group's main business (within article 2(1)(i))?</p>
2(1)(d)		<p>Is it correct that "organised, frequent and systematic" is a low threshold for firms to pass?</p> <p>In what circumstances does a person trading in OTC markets "provide a system accessible to third parties"?</p>
2(1)(i)		<p>If this exemption is not available to members of banking or investment firm groups, then must all unregulated entities bring their treasury dealings within article 2(1)(d)?</p> <p>Is "dealing on own account" limited to cases where the firm is exposed to market risk (i.e. it excludes riskless principal trades)?</p> <p>What activities are "ancillary" to the group's main business beyond pure hedging activities?</p> <p>Is the reference to "commodity derivatives" limited to those derivatives now regulated under Section C of the Annex?</p> <p>What is the definition of "group" (e.g. does it include minority participations)?</p>
2(1)(k)		<p>See above relating to "dealing for own account", "commodity derivatives" and "group".</p> <p>How does the exemption apply in relation to persons whose main business could be characterised as manufacturing, mining, extracting or generating a commodity rather</p>

		than "dealing for own account"?
2(1)(l)		Is this limited to organised markets?