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Recent Developments in the Regulation of European Commodities Markets

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In September 2010, the European Commission (EC) published the draft European Market Infrastructure Regulation (EMIR)[1], which is intended to regulate the over-the-counter (OTC) derivatives markets through enhanced market oversight, reduced operational and counterparty risk in trading, and increased market transparency.[2] The stated aim of EMIR is to introduce requirements to improve the transparency and risk management of the OTC derivatives markets, as well as uniform requirements for the performance of central clearing counterparties and trade repositories.

The EC is working towards a deadline of late 2012, set by the G-20 during the 2009 Pittsburgh Summit, by which time all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, as appropriate, and be cleared through central counterparties, again, where appropriate. Now over a year has passed since the publication of the draft regulation and, although the EC has taken steps to clarify aspects of EMIR, the final text is yet to be published. With so many issues still outstanding, including what constitutes a "standardised" OTC derivative contract, and how the term "standardised" is defined, it is not clear how realistic this timeframe is, especially as important thresholds that will determine exactly who is governed by EMIR, are only timetabled to be published later this year.

Unlike the United States, which has enacted a stand-alone piece of legislation (the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)), covering multiple aspects of governance of the commodities and commodity derivatives markets, the EC has published a myriad of legislation to accompany EMIR. This is intended to curb speculation in the market and to prevent the practice of insider trading. For the first time, the EC also has introduced legislation that specifically targets insider trading in the wholesale energy market.

Executive Summary

In October 2010, we published a White Paper (the 2010 Paper) detailing the provisions of EMIR. The 2010 Paper also considered the Dodd-Frank Act and compared certain legislative provisions of EMIR with the corresponding provisions in the Dodd-Frank Act, focusing on how market participants operating in markets both in Europe and the United States would be affected.3

This White Paper will examine the legislative developments that have taken place since the publication of EMIR and will consider what else needs to be done if the EC is to meet the G-20's deadline of bringing the legislation into force by the end of 2012. This White Paper also examines the new wave of legislation that the EC published at the end of 2011 aimed at, inter alia, stabilising the energy and commodities markets and curbing the practice of insider trading, both in the financial instruments market and the wholesale energy market.

EMIR

APPLICABILITY OF EMIR

The applicability of EMIR depends on the nature of the counterparty undertaking the OTC trade. EMIR will apply to financial counterparties, non-financial counterparties (in certain circumstances detailed below), central counterparties (CCP) and trade repositories. EMIR does not apply to European central banks, public bodies managing debt, and multilateral development banks. The definition of financial counterparties includes, inter alia, banks, investment firms, insurance, assurance, and reinsurance companies, undertakings for collective investment in transferable securities, institutions for occupational retirement provision, and alternative investment funds managers. In order to be subject to EMIR, the financial counterparty must be established in the European Union. The establishment requirement has raised numerous questions that are discussed in further detail below.

Non-financial counterparties are defined by elimination: an undertaking that is neither a central counterparty, nor a financial institution, and which is established in the European Union.

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[1] 2010/0250 (COD).
[2] All terms not defined herein are to be construed as defined in the relevant piece of legislation.
[3] For background on EMIR and the Dodd-Frank Act, and a comparison of the two pieces of legislation, please refer to the 2010 Paper EU Financial Reforms - Impact on Commodities Markets

TERRITORIAL SCOPE

The precise territorial scope of EMIR has not yet been defined. The Markets in Financial Instruments Directive (MiFID) is incorporated into EMIR by reference and, when revised, will apply to trades that could have a "direct, substantial, and foreseeable effect" within the European Union. The meaning of the terms "direct, substantial, and foreseeable" within this context is still to be defined. It is unlikely that the territorial scopes of EMIR and MiFID will differ greatly, so it can be assumed that EMIR's territorial scope will be based on market effect, rather than geographical boundaries.

If this definition of territorial scope is used, it is unclear exactly how counterparties with a group parent based outside the European Union will be affected, particularly in the context of intra-group transactions. On a narrow interpretation of EMIR, the group in question would have to have a parent based in the European Union in order to come within the scope of the legislation. However, this interpretation would exempt a great number of counterparties and could thus be seen to defeat the very purpose of EMIR. Therefore, it will be necessary for the EC to clarify exactly how groups with a parent based outside the European Union are to be affected.

Equally, it is not yet certain how EMIR will impact on the foreign branches of entities incorporated in the European Union. Likewise, an entity with branches in the European Union and the United States, for example, may be subject to obligations arising under both EMIR and the Dodd-Frank Act.

Although the territorial scope of the Dodd-Frank Act is not stated expressly as being applicable to trades undertaken outside the United States, US regulators may impose regulations on entities in those countries with regulations that may affect the financial stability of the US markets. For certain obligations—provided for in both EMIR and the Dodd-Frank Act—provisions may be conflicting. For example, under the Dodd-Frank Act, clearing obligations (discussed in further detail below), are determined according to the type of contract being cleared. Under EMIR, the clearing obligations are determined according to the status of the counterparties to the contract. A situation may arise whereby the status of the contract requires that it be cleared pursuant to the Dodd-Frank Act, but the status of the counterparty does not necessitate that the contract be cleared pursuant to EMIR. Therefore, even if a party is based in Europe and is not required by EMIR to clear its contracts, if US regulators are of the view that the contract will affect the financial stability of the United States, then the party will be under an obligation to clear the contract[4]. To date, no regulatory guidance has been issued to explain which jurisdiction's regulations take priority when an entity is subject to regulation in multiple jurisdictions.

THIRD COUNTRY CCPS

One of the issues which the legislatures took time to agree on was the application of EMIR to CCPs from third countries (*i.e.,* CCPs located outside the European Union). Previously, there was uncertainty in the market as to how third country CCPs would be treated. The text, as agreed by the EU Council of Finance Ministers (ECOFIN) on 24 January 2012, states that CCPs from third countries will be recognised in the European Union if the legal regime of the relevant third country provides for an effective equivalent system for the recognition of CCPs authorised under foreign legal regimes.

The adoption of this provision complies with the over-arching European principles of reciprocity and non-discrimination, ensuring that all CCPs, whether or not they are in the European Union, are judged by the same standards under EMIR.

CLEARING

Financial counterparties, and non-financial counterparties that come within the scope of EMIR, will be required to "clear" eligible derivatives transactions through a CCP based in the European Union. For the purposes of EMIR, "clearing" refers to the process of substituting one of the original counterparties in a trade for a CCP. Thus, when a contract is cleared, the CCP becomes the buyer to the seller and the seller to the buyer.

Other than being subject to "administrative fines" imposed by the EC, the level of which will be set after the EC has consulted with the European Securities and Markets Authority (ESMA), it is not clear what the consequences will be for failing to clear a contract. For example, it is not known whether the contract will be deemed void and/or unenforceable.

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[4] In this paragraph, the US legislation has been used for explanatory purposes only: this problem could arise with conflicting legislation from any jurisdiction.

Furthermore, it is not known if a third party will be able to rely on a contract that should have been cleared, but was not. Equally, the ability of the third party to obtain some sort of remedy in the event that they suffered damage because of the co-contractor's breach is still to be clarified.

The level of fine to be imposed on those failing to clear a contract is still to be determined. ESMA will develop standards to detail the criteria that will be used to establish the level of fine to be imposed and the procedure that EU Member States should adopt when collecting the fine. EMIR states that the fine imposed must be effective, dissuasive, and proportionate. To date, there has been no indication of what the levels of such a fine could be. EMIR does state, however, that a fine will be imposed, regardless of whether the failure to clear the contract was intentional or negligent.

As set out in the 2010 Paper, there will be mandatory clearing for certain classes of OTC derivatives contracts, with EMIR setting out a "bottom-up" and "top-down" approach to clearing. The bottom-up approach requires the relevant competent authority in each EU Member State to authorise a CCP to clear a class of derivatives. The competent authority will then inform ESMA of this authorisation. ESMA will then decide whether a clearing obligation should apply to that class of derivatives in the European Union, taking into account factors such as, *inter alia*, the liquidity of the contract and the ability of CCPs to handle to likely volume of contracts. The top down approach refers to ESMA and the European Systemic Risk Board together identifying contracts that should be subject to the clearing obligation, but for which no CCP has yet received authorisation.

Adopting both a top-down approach and a bottom-up approach could result in the requirements of one EU Member State being imposed on all the other 26 Member States. This approach seems to preclude the ability of individual Member States to draft and apply nuanced legislative solutions that address the specificities of their markets: what is beneficial for one Member State may not necessarily be so for others.

Following the meeting of ECOFIN on 24 January 2012, it was agreed that pension schemes would be exempt from the clearing obligations for a period of three years, extendable by another two years plus one year, subject to reports justifying the extensions. Therefore, irrespective of the status of the parties undertaking the trade, pension scheme contracts will not be subject to the clearing obligations.

REPORTING

Once a transaction has been cleared, it must be reported to a trade repository. A counterparty to a contract is entitled to delegate the reporting of the contract to the other counterparty. EMIR prescribes the form such a report must take, along with the minimum information that must be included, namely

- The parties to the contract and, where different, the beneficiary of the rights and obligations arising from it;

- The main characteristics of the contract, including the type, underlying, maturity, and notional value.

EMIR imposes an obligation of real-time public reporting, so the provision of a report relating to a particular trade cannot be delayed unduly.

NON-FINANCIAL COUNTERPARTIES

Under EMIR, non-financial counterparties will only be subject to the reporting and clearing obligations if their OTC derivatives positions exceed prescribed thresholds, at which point the positions are considered to be systemically important. Non-financial counterparties will be required to justify exceeding those thresholds.

Furthermore, when calculating the positions taken by non-financial counterparties under an OTC derivatives contract, the positions that are "directly linked" to the commercial activity of that non-financial counterparty will not be taken into account in calculating its position limits. For example, energy suppliers selling future production will be treated as undertaking legitimate hedging activities arising from, and relating directly to, their underlying commercial activity. Therefore, such hedging would not count towards ascertaining whether or not the non-financial counterparty has exceeded the clearing threshold.

The uncertainty that arises when establishing i) whether or not a non-financial counterparty is undertaking trading directly linked to its commercial activities; and ii) whether this, in turn, means that the prescribed threshold has been exceeded, raises the question of what constitutes a position that is directly linked to the non-financial counterparty's commercial activity. The term "hedging" is yet to be defined for the purposes of EMIR, but this could potentially be a thorny issue, as regulators might struggle to impose a (potentially reductive and simplistic) distinction between trading that is done for "pure" hedging purposes, as against trading done for "speculative" purposes. For example, it is unlikely that a non-financial counterparty would be able to claim to undertake 100 per cent of its trading on a hedging basis, particularly in relation to non-physical trades conducted with financial counterparties.

The thresholds that trigger the clearing and reporting requirements are timetabled to be published by ESMA by 30 June 2012. There have, however, been some indications that this date will not be met and the thresholds will not be published before 30 September 2012. No indication (at the time of publishing) has been given of how high or low these thresholds are likely to be, and there has been no indication as to what metric will be used as a basis for formulating these thresholds.

Non-financial counterparties will be required to monitor their activities very carefully. The counterparty's trading activities may not cross the prescribed thresholds at the outset when EMIR first comes into force. However, they may soon thereafter cross the prescribed threshold, thus triggering the clearing and reporting obligations. Consequently, trading activities have to be closely monitored to ensure that counterparties remain fully compliant with the legislation at all times.

FRONTLOADING

Not all provisions of EMIR will come into effect at the same time. As currently drafted, there will be a time delay between the regulation coming into force and the clearing provisions in the regulation taking effect. This may lead to what is known as "frontloading", whereby contracts that are entered into, or novated, prior to the coming into force of the clearing provisions (but after EMIR has come into force), have to be cleared when the provisions do come into force and the contract is yet to mature.

The clauses of the relevant trading contract will, therefore, have to be changed or amended after the contract has been entered into. For example, terms regarding the pricing of the contract might have to change, and provision will have to be made in the contract for a CCP that will clear the contract. Certain counterparties might have entered into contracts on the basis that they do not have to be cleared, but may now discover that a clearing obligation will be imposed. The requirement to clear a contract adds a financial burden and may create a delay in the contract being fully realised; two factors that the counterparties may not have considered when entering into the contract pre-EMIR.

The retroactive effect of this provision will put a burden on CCPs, which will be under an obligation to clear large numbers of trades swiftly once the clearing provisions come into force. It is interesting to note that the corresponding provision in the Dodd-Frank Act does not have retroactive effect, demonstrating that EU regulators have taken a more literal approach to clearing obligations.

Consequently, those entering into a trading contract before EMIR comes into force, or once EMIR has come into force but before the clearing requirements come into effect, should map out the maturity dates of the trades governed by the contract, to ascertain whether or not the trades will mature before or after the clearing requirements come into force. This will ensure that counterparties are (operationally and otherwise) prepared for the additional obligations that are brought about by clearing.

TIMETABLE FOR IMPLEMENTATION

The European Parliament is set to agree on a final text of EMIR during a plenary session that will be held between 13 and 16 February 2012. Once the final text has been agreed, it will be voted on in the European Parliament and by the European Council. No major changes are expected to be made to the legislative texts and the votes by the Parliament and the Council are seen as no more than a basic formality. However, as technical standards may not be published until the end of September 2012, it is not possible to view a definitive version of the text yet.

The end of 2012 has been set tentatively as the date by which EMIR will come into force, thus meeting the G-20's target date for having cross-border regulation in place to improve market transparency and manage any risks presented by the OTC derivatives markets. However, as the provisions of EMIR will not all come into effect instantly, market participants will have a fixed period of time within which measures can be put in place to ensure full compliance with the legislation. Market participants are strongly advised not to wait until the legislation comes into force before making the appropriate amendments to their business. The "go live" dates for various provisions will differ, so market participants should keep abreast of developments concerning the implementation timetable. Timely updates, alerting market participants to the "go live" dates, and the prescribed technical standards will be available on the McDermott Will & Emery energy blog website: http://www.energybusinesslaw.com/.

As it is a regulation, EMIR will be directly applicable in all EU Member States 20 days after its publication in the Official Journal, which means it will not need to be transposed into national law by means of implementing legislation. This ensures that there is consistency in the approach adopted by the 27 EU Member States. If EMIR is indeed brought into force by the end of December 2012, market participants will need to act quickly to ensure that they have the requisite systems in place to ensure compliance with the legislation.

New Legislative Texts

As well as EMIR, the EC has drafted further legislation and revised certain long-standing legislative texts, which, when they come into force, will work alongside EMIR to improve, inter alia, the integrity and stability of the commodity and commodity derivatives markets. The legislative principles that the EC has recently published which will affect commodity market participants are

- The revisions to MiFID, referred to herein as MiFID II[5], and the Markets in Financial Instruments Regulation (MiFIR)[6], published on 20 October 2011.

- The Market Abuse Regulation (MAR)[7] and the Directive on Criminal Sanctions for Insider Dealing and Market Manipulation (CSMAD)[8], also published on 20 October 2011.

- The Regulation on Wholesale Energy Market Integrity and Transparency (REMIT) of 25 October 2011.[9]

MiFID II and MiFIR

The EC undertook a thorough review of MiFID as part of its commitment to increase the supervision of the commodity derivatives market. Originally, it was thought that MiFID would be only tweaked, to bring it in to line with other legislation, including EMIR. However, following the publication of the proposed text of MiFID II, it became clear that the EC had decided to undertake a more comprehensive reassessment.

The EC's fervour for reviewing MiFID thoroughly was further demonstrated by the publication of MiFIR. MiFIR contains some of the provisions that were dealt with previously by MiFID.

The stated objectives of MiFID II are i) the protection of investors, including retail, professional and counterparty investors; and ii) the creation of an integrated financial market, in which investors are protected effectively and the efficiency and integrity of the overall market are safeguarded. MiFIR deals with matters including the disclosure and publication of data and information, rules regarding access to clearing facilities, and third parties providing services in the European Union without opening a branch therein.

APPLICABILITY

MiFID II applies to commodity derivatives that come within the definition of "other financial derivative instruments", regardless of the underlying physical commodity. It is expected that, following the reforms, more firms undertaking the trading of commodities and commodity derivatives will be brought within the scope of MiFID II. It will be mandatory

[5] 2011/0298 (COD).
[6] 2011/0296 (COD).
[7] 2011/0295 (COD).
[8] 2011/0297 (COD).
[9] Regulation (EU) No. 1227/2011.

for those venues that trade liquid commodity derivatives to publish aggregated weekly breakdowns of the positions of different market participants (without naming those participants). This information will have to be provided to the competent national authority, if so requested. Furthermore, the competent authorities will have the right to:

- Request information from market participants concerning the size and rationale for a position in a commodity derivatives contract.

- Limit the capacity of a person or class of persons from entering into a commodity derivative contract.

- Request the reduction of the size of the position in the derivative contract. This would apply to individual contracts for built-up positions.

LEGISLATIVE CHANGES

The reason why more firms will come within the scope of MiFID II and MiFIR is because certain exemptions that were available previously for commodity firms will now either be narrowed, or removed completely. For example, the exemption found in Article 2(1)(k) MiFID, exempting those whose main business consists of dealing on their own account in commodities and/or commodity derivatives will be deleted. The exemption in Article 2(1)(i) MiFID covering persons dealing on own account in financial instruments, or providing investment services in commodity derivatives or derivative contracts to the clients of their main business (provided this is ancillary to their main business), will be narrowed. First, the term "ancillary" will be defined very narrowly and ESMA will provide technical measures clarifying whether or not an activity may be considered ancillary on a group level. Second, the exemption will no longer apply to persons dealing on own account with clients of the main business.

Consequently, not only will more firms come within the scope of MiFID II, but more products will be defined as financial instruments, thus bringing them within the scope of MiFID II. For example, emissions allowances may now be classed as financial instruments, so companies that are trading emissions allowances and have hitherto been unauthorised and/or exempt, must ensure that they are sensitised to and compliant with the provisions of MiFID II, in the event that emissions allowances are brought within the scope of MiFID II.

The final text of MiFID II is still subject to approval. Both the European Parliament and the European Council are yet to comment on the proposed text and there is no published timetable for these negotiations. MiFID II is, by reference, incorporated into EMIR, so any amendments to the proposed text for MiFID II will need to be monitored on an ongoing basis, in order to ascertain fully its interoperability with EMIR.

STATUS AND TIMETABLE FOR IMPLEMENTATION

A fundamental difference between MiFID II and MiFIR is their legal status. As MiFIR is a regulation, it will be directly effective in all EU Member States once it comes into force; EU Member States will not be required to draft any implementing legislation. This will therefore facilitate and expedite its implementation. MiFID II, on the other hand, as a directive rather than a regulation, will require implementing legislation in each EU Member State in order to be transposed into national law, thereby delaying its entry into force.

Requiring implementing legislation could present problems regarding differing legislative principles for implementation, and open MiFID II to susceptibility of being implemented differently in each EU Member State. Although they are unlikely to differ greatly, the small discrepancies between each EU Member State's implementing legislation could result in caveats in the law, and could lead potentially to regulatory arbitrage. If one EU Member State's implementing legislation is more favourable than that of another, a market participant may choose to do business in the EU Member State in which the implementing legislation is better suited to their business. However, the leeway afforded to the governments of EU Member States when implementing directives is unlikely to be so material that truly significant issues of regulatory arbitrage would arise.

No definitive timetable for the implementation of MiFID II has been published yet, although it is unlikely that any legislative changes will take place before 2013. However, as with EMIR, market participants are advised to start adopting procedures as quickly as possible to ensure compliance with the directive and avoid being non-compliant when the provisions come into force. Due to their interoperability, the timetable for the implementation of MiFID II will heavily affect the timetables for the implementation of the CSMAD and MAR. As there are definitions in MiFID II are incorporated by reference into the CSMAD and MAR, the latter two pieces of legislation will not be implemented until a definitive version of MiFID II has been brought into force.

MAR and the CSMAD

The introduction of MAR is designed to cover "market abuse". "Market abuse" refers to behaviour that is contrary to market standards and causes distortion to the markets, such as insider dealing and market manipulation. The CSMAD sets out the criminal sanctions that will be faced by those guilty of market abuse. The EC was of the view that the existing market abuse directive10 (MAD) needed to be revised, as it was no longer fit for purpose: there were gaps in the regulation of the trading of OTC financial instruments and the regulation of commodities and commodity derivatives, and a lack of legal certainty.

When the EC published its proposals for the CSMAD and MAR, it stated that both should be revised in tandem with MiFID as, taken all together, the three pieces of legislation "guarantee the competitiveness, efficiency, and integrity of EU financial markets."11 Furthermore, the three pieces of legislation need to be "coherent and support each other's objectives and principles".12 The EC recognises that, as most market participants will be regulated by MAR, CSMAD, and MiFID II, there is a strong need for cohesion, without which, participants could be subject to conflicting regulatory requirements.

MARKET ABUSE

The CSMAD, MAR and REMIT all focus on eliminating market abuse on a European-wide level. The primary difference between the CSMAD and MAR (collectively), and REMIT is that CSMAD and MAR, together with MiFID, concentrate on regulating market abuse in, predominantly, financial instruments and derivatives admitted to, and/or traded on, regulated markets, whereas REMIT focuses on the regulation of market abuse specifically in the energy sector. It targets the physical energy products themselves, irrespective of whether or not they are admitted to, and/or traded on, regulated markets.

REMIT does not affect the scope of the CSMAD, MAR or MiFID II, and *vice versa*. REMIT represents a sector-specific, bespoke framework for commodities and closes a lacuna that existed previously in the legislation and saw physical energy products and markets not being regulated sufficiently.

OVERVIEW OF THE PROVISIONS OF MAR

MAR will contain provisions to increase market integrity and ensure protection for investors. The scope of the provisions in MAR is wider than the scope of the provisions in MAD. MAR adopts a tripartite approach to dealing with market abuse.

First, the scope of the financial instruments that will be covered by MAR is wider than that which was covered by MAD. MAD only applied to instruments admitted to trading on a regulated market. MAR, however, will apply to financial instruments traded on multilateral trading facilities or other organised trading platforms, financial instruments traded OTC, and regulated markets. Such changes will bring MAR in line with MiFID II. MAR also will now apply to both the commodity and the commodity derivatives markets.

Second, the offence of "attempted" manipulation of financial instruments has been introduced. The notion of attempted manipulation was included within the definition of insider dealing in MAD, but MAR makes it a stand-alone offence. The preamble to MAR gives some examples of behaviour that would constitute attempted manipulation. These include placing orders that may not be executed and disseminating false and/or misleading information.

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[10] 2003/6/EC.

[11] Europa.eu: "Press Release: Proposals for a Regulation on Market Abuse and for a Directive on Criminal Sanctions for Market Abuse - Frequently Asked Questions." October 2011.

[12] *Ibid.*

Finally, MAR strengthens the investigative and sanctioning powers of the regulatory authorities, to cover both suspicious unexecuted orders and suspicious OTC transactions. ESMA is required to ensure that there is harmonisation and coordination of the rules covering the detection and notification of suspicious transactions.

The proposed sanctions and fines that may be imposed by regulatory authorities are set out in MAR. These include the right to request the freezing and/or sequestration of assets, seizing documents, the right to enter into private premises, having access to telephone and data traffic records, and a suspension of trading of the financial instruments concerned. The level of fines imposed could be up to twice the amount of profits gained or losses avoided as a result of the breach of MAR, where the gain or loss can be calculated. For a natural person, the fine could be up to €5 million (although this figure could change prior to the final version of the regulation coming into force) and for a legal person, the fine could be up to 10 per cent of the total annual turnover for the previous business year.

These changes represent the recognition by the EC that the markets on which financial instruments are traded have changed significantly since the drafting of MAD. It was, therefore, essential to expand the market abuse regime, in order to bring it in line with developing market practices.

OVERVIEW OF THE PROVISIONS OF THE CSMAD

The CSMAD will define the most serious market abuse offences and will set the minimum levels of criminal sanctions that will be imposed on those found guilty of the offences. The preamble to the CSMAD states that the current sanctions imposed on those found guilty of market abuse are not impactful or sufficiently dissuasive, rendering the current regime insufficiently effective. Furthermore, as the regime stands currently, the definition of behaviour that is considered to be insider dealing or market manipulation differs in each EU Member State. As MAD should have been a cross-border, European-wide regime, having such divergent definitions also undermines its effectiveness as a directive applicable to 27 EU Member States.

The CSMAD will operate in tandem with MAR. In order to bolster the existing regime, the CSMAD defines two separate offences: i) insider dealing and ii) market manipulation. If either of these are committed intentionally, they should be classed by EU Member States as a criminal offence. Inciting, aiding, abetting, and attempting any of these criminal offences also should be classed as a criminal offence.

The CSMAD will impose liability on legal persons when market abuse is undertaken by their employees due to a lack of supervision, or when the firm is the beneficiary of the market abuse.

The EC will be required to report on the efficacy of the CSMAD within four years of its entry into force. If necessary, the report will be accompanied by legislative proposals.

EXCLUSIONS

Certain transactions are expressly excluded from the scope of both MAR and the CSMAD. These are buy-backs and stabilisation programmes, monetary policy and public debt management activities, and activities concerning emission allowances in pursuit of climate policy. Neither MAR nor the CSMAD state precisely why these categories of trades have been excluded from the legislation. It is too early to tell what effect these exclusions could have.

STATUS AND TIMETABLE FOR IMPLEMENTATION

As discussed in relation to MiFID II and MiFIR above, a fundamental difference between the CSMAD and MAR is their legal status: CSMAD requires each EU Member State to introduce implementing legislation, while MAR is directly applicable in each EU Member State. Requiring each EU Member State to have separate implementing legislation brings with it the same potential for problems that were discussed above in relation to MiFID II and MiFIR, namely the potential for regulatory arbitrage. The advantage of a having a regulation in place is the anchor of legal certainty that is afforded to market participants relying on it, knowing that it will be the same in each EU Member State.

EU Member States will have two years after the CSMAD is adopted to bring it into force. Within this period, EU Member States will have to provide the EC with the text of the directive and with all the requisite laws, regulations, and administrative provisions that are required in order to be fully compliant with the directive. MAR will begin to apply two years after its entry into force.

ESMA will develop technical standards, as it will do with EMIR, which will determine the procedures that need to be complied with, and detail the systems to be put in place and the types of notifications that will have to be made in the event of suspected market abuse. The proposed text of MAR does not give a date for when ESMA will be required to submit these technical standards.

Discussions on both MAR and the CSMAD will run in parallel, with provisional indications suggesting that a final text for both will be sent to the European Council and the European Parliament for approval by the end of summer 2012. Approval will most likely be given after the requisite technical standards have been published, so the relevant quantum that will be imposed on the markets—and its potential for abuse—is clearer. As mentioned above, the definitive timetable for implementation will depend very heavily on the timetable for the implementation of MiFID II, given the interoperability of the texts.

REMIT

On 28 December 2011, REMIT entered into force. REMIT imposes requirements aimed at preventing and detecting market abuse or, more specifically, market manipulation and insider trading in the wholesale energy market.

REMIT represents the first time that market abuse regulation in the wholesale energy market has been undertaken on an EU-wide level. The overarching aim of REMIT is to ensure that end-user prices reflect wholesale price levels, with prices reflecting accurately the interplay between supply and demand.

As a regulation, REMIT has direct effect in all EU Member States, making it uniformly and simultaneously applicable in all EU Member States. Market participants are encouraged to act as quickly as possible to ensure that they are fully compliant with the provisions of REMIT. Actions that may need to be taken include, inter alia, the installation of firewalls, the adoption of new disclosure procedures, and having in place a secure and thorough compliance framework.

Both market manipulation and insider trading are defined in the regulation itself. Moreover, REMIT sets out two further obligations: an obligation to publish inside information and the establishment of a system of market monitoring.

PROHIBITION ON INSIDER TRADING

REMIT introduces a ban on using inside information, disclosing inside information, and recommending and/or inducing another person to acquire or dispose of wholesale energy products. Inside information is defined in REMIT as being

…Information of a precise nature which has not been made public, which relates, directly or indirectly, to one or more wholesale energy products and which, if it were made public, would be likely to significantly affect the prices of those wholesale energy products.

The prohibition applies to the following people: members of the administrative, management or supervisory bodies of an undertaking; persons with holdings in the capital of an undertaking; persons with access to the information through their employment, profession or duties; persons who acquired such information through criminal activity; and persons who know, or ought to know, that it is inside information.

REMIT's scope is limited to "wholesale energy products", thereby making it much narrower in scope than the CSMAD and MAR. It is important to note that it does not apply to all commodities. The four products that fall within the wholesale energy products category are contracts for the supply of electricity or natural gas; derivatives relating to electricity or natural gas; contracts relating to transportation of electricity or natural gas; and derivatives relating to transportation of electricity or natural gas, irrespective of where or how they are traded, thus covering OTC transactions as well. REMIT does not include contracts for gas or power supply to end-users, unless the end-users' consumption of the gas or power exceeds 600 GWh/year. If this threshold is crossed, the power or gas is treated as a wholesale energy product.

OBLIGATION TO PUBLISH INSIDE INFORMATION

Market participants, whether natural or legal persons, are required to disclose publically inside information that they possess in respect of businesses or facilities for which the participant concerned, or its parent company or related undertaking owns or controls, or for which the participant is responsible for operational matters. There is not yet a prescribed format for such disclosure.

There are exemptions to the general rule regarding disclosure, particularly when disclosure may prejudice a legitimate interest. In such circumstances, disclosure may be delayed, but an omission to disclose information must not mislead the public. Furthermore, the market participant must ensure confidentiality of the information, and they may not use the information to trade in wholesale energy products. Once practicable, the market participant must immediately communicate the information and then state his justification for the delay.

PROHIBITION ON MARKET MANIPULATION AND ATTEMPTS TO MANIPULATE THE MARKET

REMIT prohibits engaging in, or attempting to engage in, market manipulation on wholesale energy markets. Such activity constitutes the provision of misleading information in relation to the availability of electricity generation capacity or gas availability, or representing that the availability of transmission capacity is something other than the capacity actually physically available. Neither the CSMAD nor MAR expressly prohibit market manipulation in the markets that they apply to. This demonstrates that the EC has chosen to adopt a stricter approach in terms of regulating the wholesale energy markets.

The preamble to the regulation defines what market manipulation means, by referring to behaviour that artificially alters prices and which cannot be justified by supply and demand on the market, such actual availability of production, storage or transportation capacity and demand. It then goes on to set out behaviour that would constitute market manipulation, which includes, *inter alia*, the placing of false orders, spreading false rumours through the media (including the internet), and deliberately providing false information to undertakings which provide price assessment or market reports. Such manipulation may occur across borders, between power and gas markets, and across financial and commodity markets, including the emission allowances markets.

MARKET MONITORING BY THE AGENCY FOR THE COOPERATION OF ENERGY REGULATORS

REMIT introduces a two tier monitoring system: i) the Agency for the Cooperation of Energy Regulators (ACER) is responsible for monitoring market abuse on a Europe-wide level, and ii) national regulatory authorities (NRAs) are responsible for monitoring the markets on a EU Member State-level. By introducing this two tier system, there could potentially be blurred boundaries regarding division of responsibility, with ACER taking on the role of the NRAs and *vice versa*. As set out below, the roles of both ACER and NRAs are closely linked; however, where the role of one stops and the role of the other starts has not been made explicitly clear. It might take some time before the limits of their respective oversight and jurisdiction are precisely defined.

ACER

ACER is charged with monitoring these markets, ensuring coordination of NRAs in each of the EU Member States, and seeking to prevent and identify instances of insider trading and market manipulation.

ACER issued non-binding guidance (the Guidance) on the application of definitions in REMIT in December 2011[13], along with a question and answer booklet.[14] The Guidance states that further guidance will be issued by ACER in the first half of 2012. The Guidance on the definitions in Article 2 of REMIT is targeted at NRAs and clarifies what ACER considers to be inside information, market manipulation, and what the signs that may suggest these activities are taking place. Annexed to the Guidance is a form that can be used when reporting suspicious transactions. The form is not mandatory, but ACER does urge those reporting suspicious transactions to use it, as the questions cover all the areas of information that ACER needs to know about regarding the suspicious activity. If not using the form, then the person reporting a suspicious transaction must, at the very least, state why they believe that the suspicious transaction might constitute insider dealing or market manipulation.

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13 http://www.acer.europa.eu/portal/page/portal/ACER_HOME/Activities/REMIT/1st%20edition%20ACER%20guidance%20111218%20ap%20vz%20clean%20ap%20clean%20sonia.pdf

14 http://www.acer.europa.eu/portal/page/portal/ACER_HOME/Activities/REMIT/QuestionsAndAnswers3%20ap_final%20vzu_cca.pdf

NRAs

NRAs, both those in regulatory and financial services (Ofgem and the Financial Services Authority in the United Kingdom) and competition authorities will be required to coordinate with ACER, to ensure market participants comply with the requirements. ACER will submit annual reports to the EC in relation to the potential for, and incidence of, market abuse.

Each EU Member State must ensure that its NRAs have the necessary investigatory powers, which shall be exercised in a proportionate manner. The investigatory powers NRAs may be charged with, include the right to

- Have access to any relevant documents in any form and to receive a copy of them.
- Demand information from any person, including those who are successively involved in the transmission of orders or conduct of the operations concerned, as well as their principals and, if necessary, to summon and hear any such person.
- Carry out on-site inspections.
- Require existing telephone and existing data traffic records.
- Require the cessation of any practice that is contrary to REMIT.
- Request a court to freeze or sequester assets.
- Request temporary cessation of professional activity.

Obligations will be introduced forcing energy traders to report transactions to ACER. ACER will be responsible for monitoring and analysing all trades and for verifying that the rules are followed, and will instruct NRAs to investigate any incidents of market abuse.

Wholesale energy market transparency will be enhanced by establishing a European register of market participants, based on national registers. Participants will be required to register with one authority only: the authority of the EU Member State in which the participant is established or is resident. If neither applies to the participant it must register in an EU Member State where it is active. The EC will adopt implementing acts defining the scope of trade reporting and registering obligations. EU Member States must establish registers of electricity and natural gas traders three months after the adoption of the implementing acts, with transaction reporting requirements entering into force three months later.

EXCLUSIONS

Unlike the CSMAD and MAR, where certain transactions are expressly excluded and are not governed by the two pieces of legislation, certain products in the wholesale energy market are excluded from REMIT by elimination. REMIT makes no mention of carbon, coal, and oil. It is thought that the reason REMIT does not apply to these other energy commodities is because their markets are more truly international and borderless, therefore making it more problematic to impose uniform and meaningful regulations on them.

PENALTIES

REMIT does not prescribe the sanctions that will be imposed on those breaching the legislation. Instead, it will be up to EU Member States to set the penalties that will be faced by those who infringe REMIT. The penalties must be effective, dissuasive, and proportionate, in order to achieve the regulation's underlying objective. EU Member States must notify the EC of the penalties by summer 2013-18 months after REMIT has come into force.

Further Reforms

CAPITAL REQUIREMENTS DIRECTIVE

The EC is currently in the process of undertaking a review of the directives that make up the Capital Requirements Directive (CRD)[15]. The EC's proposed draft[16] of the revised CRD reflects the requirements put forward by the Basel Committee of Banking Supervision, which develops minimum standards on bank capital adequacy. The CRD, which will be split into a directive and a regulation, will allow the EC to introduce a supervisory architecture into the financial services sectors of all EU Member States.

The EC states that the overriding objective of the revised CRD is to strengthen the resilience of the EU banking sector so that it is better placed to absorb economic shocks but at the same time is able to ensure economic activity and growth. The Capital Requirements Regulation (CRR) will introduce "a single rule book", setting out a single set of harmonised prudential rules, which are designed to close any regulatory caveats and contribute to a more effective functioning of the European financial market. The CRR will also contain provisions on own funds, capital requirements, and disclosures made by firms.

Consultations regarding the definitive text of the CRD and CRR are ongoing and are expected to conclude by the end of the summer 2012, which is the EC's preferred deadline for the conclusion of legislative negotiations. The revised CRD is due to become binding on 1 January 2013.

THE AMENDING DIRECTIVE

The Amending Directive[17], adopted on 24 November 2010, revises the Prospectus Directive[18] and the Transparency Directive[19]. The Amending Directive came into force on 31 December 2010 and EU Member States have until 1 July 2012 to implement it.

The Amending Directive prescribes requirements that will have to be adopted by those publishing prospectuses, and the information they have to provide regarding securities. Although this piece of legislation will not affect all participants in the commodity and commodity derivatives markets, it will be of importance to those offering their shares on regulated markets.

Conclusion

The enhanced regulation of the European commodities and commodity derivatives markets demonstrates the EC's ambition to tame markets that were previously regarded as being subject to "light-touch" regulation. Although much of the detail is still unconfirmed, the EC has given market participants sufficient information to start making the changes required to ensure that their business practices are fully compliant with the new legislation, once it comes into force. Market participants should avoid waiting until all the legislation is finalised, as this might not afford them sufficient time to become fully compliant.

Given the rapidity of legislative developments that have taken place over the past 18 months alone, market participants would be advised to continue actively monitoring the ongoing developments and changes. The sheer volume of legislation that will now be governing these markets shows that the EC is of the view that a comprehensive change was long overdue.

It is as yet unclear whether the division of MiFID, MAD, and CRD into directives and regulations makes them more or less effective. However, this appears to be a new approach that the EC is keen to promulgate. It seems the EC expects that the division will make the legislation more fit for purpose and more in line with the legislative requirements needed to bring market participants in line.

[15] 2006/48/EC and 2006/49/EC.
[16] 2011/0203 (COD).
[17] 2010/73/EU.
[18] 2003/71/EC.
[19] 2004/109/EC.

It also remains to be seen how the European legislation will interact with the Dodd-Frank Act, and whether those counterparties who actively trade both in Europe and the United States will be able to comply with all the relevant legislation effectively, without there being any conflicts in the provisions and consequent operational issues. It will only be possible to stand back and make a meaningful assessment on what this bodes for market participants once the European legislation has been fully finalised.

Glossary

Acronym / Shortened Name	Full Name
ACER	Agency for the Cooperation of Energy Regulators
CCP	Central Clearing Counterparty
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CSMAD	Criminal Sanctions for Insider Dealing and Market Manipulation
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
EC	European Commission
ECOFIN	EU Council of Finance Ministers
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
EU	European Union
G-20	Group of 20. The world's 19 biggest economies and the European Union
MAD	Market Abuse Directive
MAR	Market Abuse Regulation
MiFID	Markets in Financial Instruments Directive
MiFID II	Revised Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
NRA	National Regulatory Authority
OTC	Over-the-Counter
REMIT	Regulation on Wholesale Energy Market Integrity and Transparency

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