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Broad MiFID Review to Change the Landscape of the Commodity Derivative Markets

December 21, 2010

On 8 December 2010, the European Commission (EC) published a far-reaching consultation on the revision of the Markets in Financial Instruments Directive (MiFID). The review of MiFID (Review), the principal piece of European securities legislation, is part of the EC's ongoing efforts to fulfil the targets set out by the G-20 "to improve the regulation, functioning, and transparency of financial and commodity markets to address excessive commodity price volatility". The EC's approach to achieving the heightened transparency is three-fold:

- The formal proposals set out in September 2010 to regulate the over-the-counter (OTC) derivatives market through enhanced market oversight [see White Paper on EU Financial Reforms: Impact on the Commodities Market]
- The forthcoming review of the Market Abuse Directive
- The ongoing revision of MiFID

The Review is more expansive than some market commentators expected and targets areas in which shortcomings have been previously identified. Far from the expected "minor tweaks" to MiFID, the Review covers proposals relating to, inter alia, data consolidation, transaction reporting, investor protection and provision of investment services.

Commodity Derivative Markets

Among other areas of primary focus in the Review are the measures specific to commodity derivative markets. In recent years, some commentators have suggested that the increased trading of commodity futures, options and other derivatives led to an increase in the price of foodstuffs and energy, inflating them to artificially high levels. The EC therefore considers that a separate chapter should be added to MiFID to ensure that sufficient clarity and regulatory focus are devoted to how commodity derivative markets function in the future. Despite the disparities between each of the commodity markets, the EC hopes that the new regulatory framework would remain common to all of the different commodity derivatives markets.

1. Position Reporting Obligations

One of the proposals in the Review includes the standardisation of information to be reported regarding positions. Traders who trade on EU-organised trading venues, including regulated markets, multi-lateral trading facilities and organised trading facilities, would be subject to a framework which sets out position reporting obligations. The information to be reported would include the category and identity of the end client and the aggregate positions of categories of end clients. The EC considers such information would be beneficial to both regulators and market participants.

The increased reporting would go some way to resolving the issue of "dark pools", which currently allow investors to refrain from disclosing information about trades prior to their execution. Market commentators have suggested that the increasing number of dark pools could be concealing risks within the financial markets. EU Commissioner Michel Barnier, the former French agricultural minister who is in charge of the Review, stated that "if someone is doing something which affects the market then he or she must be held to account".

2. Removal of the Exemptions from MiFID

A further proposal relates to commodity firms who are currently exempt from MiFID when dealing on their own account in financial instruments. It has been suggested by national regulators and market participants that as the exempt firms are not subject to MiFID provisions, including the conduct of business rules, then unsophisticated clients (i.e., those without sufficient knowledge in the field) would not be adequately protected. The Review therefore proposes the modification of the exemptions.

The most seismic change would be the deletion of the exemption in Article 2.1(k), which currently exempts persons whose main business consists of dealing on own account in commodities and/or commodity derivatives from the requirements of MiFID. The main reasons for the deletion of the exemption are, firstly, that there is strong underlying political consensus supporting its removal and, secondly, the fact that many commodity firms are now setting themselves up as MiFID-licensed subsidiaries, which has removed the need for the exemption.

High-frequency trading (HFT) is being strongly targeted by the Review. It has been argued that HFT can affect the orderly functioning of the markets. There are concerns that not all high-frequency traders are required to be authorised under MiFID, as the exemption in Article 2.1(d) applies to persons dealing on their own account. If not subject to MiFID, the traders are not supervised by the relevant regulatory authority. High-frequency traders are able to withdraw liquidity from the market at any point and are not subject to any restrictions. The Review therefore proposes that high-frequency traders be reclassified as investment firms (and would therefore be subject to MiFID) and a more stringent system of checks and balances to ensure that their actions do not destabilise the market.

3. Trading on Exchange or Electronic Platforms

In line with the efforts to increase the stability, transparency and oversight of the OTC derivatives markets, the EC is proposing amendments to MiFID requiring all trading in derivatives which are eligible for clearing and sufficiently liquid to be traded via the organised trading venues listed above.

Trading on these exchanges or platforms would encourage pre- and post-trade transparency by requiring the reporting of transactions to trade repositories. The European Securities and Markets Authority would be charged with deciding whether a derivative which is eligible for clearing is sufficiently liquid to be traded solely on the organised venues listed above.

The EC hopes that this proposal will provide greater standardisation, increased clearing of OTC derivatives and reporting to trade repositories. This is a direct response to the G-20's commitment to greater transparency and the improved stability of the market. The Review coincides with the development of a trade repository in Hong Kong for the clearing of OTC derivatives, which is due to be launched in 2012.

4. Stronger Oversight

The Review proposes affording competent authorities with an increased role in overseeing derivative contracts. Competent authorities would be given the power to intervene throughout the various stages of a derivative contract and request the natural or legal person entering into the transaction to:

- Provide a full explanation for the position
- Provide all of the relevant documentation to the contract
- Reduce the size of the position in the interests of the orderly functioning of markets, investor protection or market integrity

This would provide greater coordination at a European-wide level, namely the convergence of approach adopted by national regulators and the application of their power, with the aim of increasing stability within the commodity markets.

Conclusion

Commissioner Barnier stated that there is no reason why the system for Europeans should be any less rigorous than the one in place for the United States. There is increasing pressure on regulators in European commodity markets to tighten regulation as plans to control speculative activity continue to be pushed forward in the United States.

The revised MiFID could become law in 2012, but prior to coming into force, it will require approval by the European Parliament. The consultation period for the Review expires at the end of February 2011, with the EC asking market participants to comment on the proposals set out in the Review. The EC proposals could therefore change prior to implementation, following the expected industry commentary. What is clear, however, is that the increased transparency and requirement for better functioning commodity markets is high on the EC's agenda.