Commodities

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REGULATION OF TRADE IN FREIGHT DERIVATIVES: BE PREPARED

From 3 January 2017 the MiFID II regulatory reform package will impose major new obligations on businesses dealing in energy, commodities, freight and emissions. MiFID II extends and updates the 2004 Markets in Financial Instruments Directive (MiFID), which sets out the EU's investment services and markets regime.

Many commodity market participants will need to become authorised for the first time under MiFID II and even non-authorised firms may be affected by new restrictions on the size of commodity positions. It is therefore essential that participants assess their trades under the new rules to determine what impact MiFID II will have. In addition, non-EU firms may face significant barriers to cross-border business with EU counterparties.

MiFID II covers more contracts

MiFID already captures most freight derivatives, but MiFID II will classify a wider range of commodity (and possibly freight) contracts as derivatives, particularly where brokerage services are treated as Organised Trading Facilities (OTFs) under the new regime.

MiFID II ancillary activity exemption

Although MiFID II considerably restricts the availability and scope of existing exemptions under MiFID, certain important exemptions remain, but subject to tighter conditions. Of most relevance to those trading freight derivatives is the "ancillary activity" exemption under Article 2(1)(j) MiFID II. This has been substantially rewritten from the existing "ancillary" exemption and will introduce strict quantitative parameters to determine what is "ancillary".

holman fenwick willan hfw

The ancillary activity exemption will apply to activities in EU emissions and "commodity derivatives" (a term which extends to include freight derivatives). The exemption will be available only to firms which deal on own account in these instruments (except when executing client orders) or provide investment services (but not dealing on own account) in respect of such instruments to the customers or suppliers of their main business. These elements are subject to further conditions including that the activity is an "ancillary" activity to the main business at a group level in the EU.

Firms relying on this exemption will need to notify the relevant regulator annually and may be required to provide supporting evidence.

What is "ancillary"?

Under MiFID II, the European Securities and Markets Authority (ESMA) is required to develop regulations to specify the criteria for establishing when an activity is to be considered "ancillary". ESMA recently published a consultation paper, on these and other issues under MiFID II - the deadline for responses is 2 March 2015.

Under current proposals, the proportion of activity ancillary to main business is assessed by two main tests: the capital employed test and the trading activity test. ESMA proposes that both of these should be satisfied in the EU at group level before an entity can claim the exemption.

The thresholds currently proposed by ESMA to determine these tests are considered by many to be very low, with a 5% threshold for capital employed on MiFID II activity and a 0.5% threshold for share of EU trading volume in any of eight specific categories of derivatives.

Despite previous lobbying, and despite ESMA's acknowledging that freight trading is ancillary to the trading of other commodities, as the regulations are currently drafted freight is in a separate trading category from other commodities such as metals, oil, coal and agriculturals. By placing freight in a 'catch all' category of 'other derivatives', there is a real risk that firms with anything more than a minimal market share in freight derivatives could exceed the threshold and thereby be denied the exemption for any commodity derivatives.

Exclusions

In calculating the proportion of "ancillary" activity, "privileged transactions" are excluded – these are, broadly, certain intra-group transactions, hedges, and transactions to fulfil regulatory liquidity obligations.

Hedges can be deducted only within the relevant commodity asset classes. In the consultation process, this approach has been criticised as being at odds with commercial practice, where several commodities are co-related and often one underlying product may be hedged with a different product.

In particular, the proposed classification of freight under MiFID II means that it will be difficult for firms to exclude many freight hedges. This is because the deduction of freight hedges will not be allowed in calculating derivatives volume in commodities such as oil and coal which are in a different commodity asset class, even though freight hedges are often used to manage risk in such commodities.

Market participants are expressing concerns over this proposal, and many argue that commodities should be regrouped, with each asset class including freight hedges in respect of that commodity.

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ROBERT FINNEY, PARTNER

There is considerable doubt as to whether this will be accepted by ESMA (or in due course by the European Commission (the Commission), which adopts the regulations). ESMA must submit the draft regulations, including the delineation of asset classes, by 2 July 2015.

Third country access

MiFID II is not directly applicable in non-EU countries. However, the MiFID II directive and MiFIR (the associated regulation which is the other part of the package) make specific provision for non-EU investment firms which conduct business with or in the EU. Although in the longer term, these provisions may help freight and commodity traders from some non-EU jurisdictions to access EU markets, in the short to medium term non-EU traders are likely to encounter substantial obstacles to doing business with the EU or maintaining branches in the EU.

MiFID II attempts to create a harmonised regime for access to EU markets by non-EU firms. Under the new rules, non-EU firms may be able to provide services or perform activites within the scope of MiFID II ("MiFID II services") directly to "eligible counterparties" and "professional clients" (each as defined in MiFID II) either cross-border into the EU or through the establishment of a branch in the EU.

A non-EU firm wishing to provide MiFID II services on a cross-border basis will need to be registered with ESMA as a permitted non-EU firm. It can be registered provided that (i) it is authorised to provide the relevant investment services in its home state, (ii) the Commission has assessed its home state's legal and supervisory regime as equivalent, and (iii) appropriate co-operation arrangements are in place between ESMA and the relevant home state.

MiFIR contains transitional provisions under which non-EU firms will be able to continue to provide services and activities in accordance with national regimes until three years after the adoption of a Commission equivalence decision in respect of the relevant third country. It is uncertain whether this transitional provision will apply to services provided to all client types or whether it is limited to cross-border business.

Alternatively, EU Member States may require that non-EU firms provide MiFID II services though a branch authorised in that Member State. The non-EU firm may do so only where the Commission has first adopted an equivalence decision.

The equivalence test is likely to cause barriers to non-EU firms seeking access to EU markets. In order to establish equivalence, the home state of the non-EU firm must impose equivalent legal and supervisory requirements and an equivalent prudential framework to those applicable under MiFID II. Non-EU states may take some years to establish such provisions (and might never do so), especially over all the freight and commodities business covered by MiFID II, and the Commission may take a substantial amount of time to assess equivalence.

Until an equivalence decision is adopted in respect of any particular third country, firms from that country may be able to continue to provide MiFID II services to eligible counterparties and professional clients in those EU Member States whose national regulatory regime permits this. It is not yet clear whether the UK will maintain its relatively broad safe harbours for "overseas persons" in these circumstances, but some major states seem unlikely to allow much flexibility.

Furthermore, MiFIR contains transitional provisions under which non-EU firms will be able to continue to provide MIFID II services in accordance with national regimes until three years after the adoption of a Commission equivalence decision in respect of the relevant third country. It is uncertain whether this transitional provision will apply to MiFID II services provided to all client types or whether it is limited to cross-border business. Again, inflexibility of many national regimes is likely to restrict access by non-EU firms to many Member States.

Many non-EU firms currently trade with EU clients and counterparties on the basis of exemptions under MiFID. However, following the narrowing in scope of existing exemptions, these firms will need to reassess carefully their trading and structure. Given the current MiFID II provisions and ESMA's proposals, it is also uncertain whether the ancillary activity exemption described above will be available to non-EU firms such as traders based in Singapore and Switzerland.

Position limits

MiFID II also introduces, for the first time in the EU, mandatory legal restrictions on the scale of commercial trading in commodity derivatives traded on an EU venue and "economically equivalent OTC contracts". Daily position reporting and weekly publication of venues' aggregate positions will also be required.

In calculating position limits, certain hedges may be excluded where positions are held by or on behalf of non-financial entities. Loss of this facility is therefore a significant factor to take into account when considering authorisation under MiFID II.

Compliance with position limits rules is required of all persons, regardless of whether they are exempt from the authorisation under the provisions discussed above. The regime provides for hedges to be taken into account in calculating positions. However, this facility will be available only to non-financial entities and ESMA's proposal to require prior regulatory approval could make this hedge exemption largely inaccessible.

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Commodity position limits will apply in relation to all derivatives traded on an EU venue – whether on regulated markets, multilateral trading facilities or one of the newly authorised OTFs. Those limits will include "economically equivalent OTC contracts", which will be determined according to criteria set out in the regulations ESMA is drafting.

Where an entity holds positions on behalf of clients, then the calculation of position limits and indeed position reporting will generally require firms to look through all intermediary holders to determine the end client. In its consultation paper, ESMA proposes parameters within which national regulators will be permitted to set position limits in respect of the listed contracts for which they are responsible.

Authorisation

Firms engaged in freight and/ or commodity trading will need to consider these new rules in order to determine whether and how their trade will be impacted by MiFID II. This will be a significant undertaking, even for smaller firms.

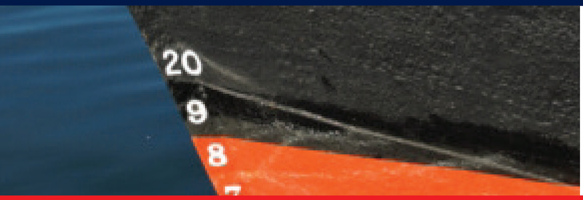
Market participants need to consider whether they fall within the scope of MiFID II or whether they can benefit from one of the available exemptions. If the exemptions do not adequately cover a firm's business then it is likely to require authorisation. For a non-EU firm this may be prohibitive before third country access applies to its home jurisdiction.

Whether or not authorisation will be required may depend upon future trading figures which will determine whether the firm needs to be authorised come 3 January 2017. How this will operate in practice is not yet clear - at present, no transitional arrangements are proposed to phase in authorisation requirements.

In order to manage the impact of MiFID II, participants may choose to restructure or restrict trading in certain areas, or otherwise change their current trading model. Participants may need to allow six months or more to obtain authorisation in advance of the rules coming into effect in 2017. Non-EU firms may need to consider establishing an EU affiliate for trading purposes and obtaining authorisation for that company.

In any event, time must be allowed for advance planning, taking into account both regulatory issues (e.g. impact of authorisation on position limits, capital and application of other regulatory regimes) and other factors (e.g. tax).

Firms need to engage actively now to avoid business disruption in 2017.



For more information, please contact the authors of this Briefing:

Robert Finney
Partner, London
T: +44 (0)20 7264 8363
E: robert.finney@hfw.com

Orla Isaacson
Associate, London
T: +44 (0) 20 7264 8101
E: orla.isaacson@hfw.com

HFW's London office is part of an international network of 13 offices in 11 countries. For further information about commodities/trade related issues in other jurisdictions, please contact:

Damian Honey
Partner, London
T: +44 (0)20 7264 8354
E: damian.honey@hfw.com

Edouard Taÿ Pamart
Partner, Paris
T: +33 1 44 94 40 50
E: eduoard.taypamart@hfw.com

Konstantinos Adamantopoulos
Partner, Brussels
T: +32 2 643 3401
E: konstantinos.adamantopoulos@hfw.com

Jeremy Davies
Partner, Geneva
T: +41 (0)22 322 4810
E: jeremy.davies@hfw.com

Dimitri Vassos
Partner, Piraeus
T: +30 210 429 3978
E: dimitri.vassos@hfw.com

Simon Cartwright
Partner, Dubai
T: +971 4 423 0520
E: simon.cartwright@hfw.com

Chris Swart
Partner, Singapore
T: +65 6411 5315
E: christopher.swart@hfw.com

Peter Murphy
Partner, Hong Kong
T: +852 3983 7700
E: peter.murphy@hfw.com

Nick Poynder
Partner, Shanghai
T: +86 21 2080 1001
E: nick.poynder@hfw.com

Gavin Vallely
Partner, Melbourne
T: +61 (0)3 8601 4523
E: gavin.vallely@hfw.com

Stephen Thompson
Partner, Sydney
T: +61 (0)2 9320 4646
E: stephen.thompson@hfw.com

Hazel Brewer
Partner, Perth
T: +61 (0)8 9422 4702
E: hazel.brewer@hfw.com

Jeremy Shebson
Partner, São Paulo
T: +55 11 3179 2900
E: jeremy.shebson@hfw.com

Lawyers for international commerce

hfw.com

São Paulo London Paris Brussels Geneva Piraeus Dubai Shanghai Hong Kong Singapore Melbourne Sydney Perth