Impact of MiFID
A guide for Commodity Traders
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<th>Abbreviation</th>
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<td>Capital Adequacy Directive</td>
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<td>CFTC</td>
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<td>COB</td>
<td>Conduct of Business</td>
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<td>CRD</td>
<td>Capital Requirements Directive</td>
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<td>EEA</td>
<td>European Economic Area</td>
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<td>EMP</td>
<td>Energy Market Participants</td>
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1. **What is MiFID?**

MiFID is the acronym for the Markets in Financial Instruments Directive (MiFID). It replaces the current Investment Services Directive (ISD) and will have potentially far reaching regulatory implications for commodity traders.

2. **What will MiFID do?**

MiFID attempts to facilitate pan-European financial market integration and regulation using the “passport” model. MiFID will allow investment firms (as defined by MiFID) to offer both products and services across the European Economic Area (EEA)\(^1\) based on a single set of rules, supervised only by their domestic regulator.

If a commodity trading firm falls within the scope of MiFID, it will be subject to a greater degree of regulation in areas such as know your customer and suitability, transaction reporting, best execution, conflicts of interest, client assets and client money, data protection and record keeping. MiFID will expand marketing opportunities, change the markets, and change relationships between market participants.

The FSA estimates the average cost of making the changes required by MiFID to be about £10,000 for a small firm (up to 100 employees), about £250,000 for a medium-sized firm (100-5000 employees) and over £7 million for a large firm (over 5000 employees).

3. **Why is MiFID important to commodity traders?**

MiFID is of importance to commodity traders for two main reasons:

3.1 **Increased regulation**

Commodity firms that do not carry out Investment Business (as defined by the ISD) within the EEA are currently relatively lightly regulated at national level and are not subject to all of the capital and other requirements imposed by the Capital Requirements Directive (a recast of the Capital Adequacy Directive).

However as a result of the width of the financial instruments covered under MiFID and the current review by the European Commission of the regulatory regime applicable to commodity derivatives and commodity firms, commodity firms will potentially become highly regulated for the first time. This in turn will lead to increased costs and will necessitate the implementation of many new working procedures.

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\(^1\) This includes the EU Member States (Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom) and EEA Member States (as for EU plus Iceland, Liechtenstein and Norway).
Despite the fact that MiFID deals only incidentally (see Recital 28 of MiFID) with commodity firms with their head or registered office situated outside the EEA, such players are likely to be affected by MiFID if they carry out investment services or activities in the EEA on a professional basis or as a regular occupation. The need for such commodity firms to apply for the appropriate MiFID permissions from each relevant Member State will need to be assessed on a case by case basis.

For instance, a non-EEA firm acting cross border into the UK should be able to rely on the “overseas person” exclusion (Art. 72 of the Regulated Activities Order 2001 (RAO)). In fact, whilst in the Consultation Paper 06/14 the FSA is equivocal on the retention of this exclusion for non-EEA firms, Her Majesty’s Treasury favours such retention in its consultation document on UK implementation of MiFID of 15 December 2005.

3.2 Marketing opportunities

MiFID will also afford new opportunities to commodity firms subject to MiFID, as it will allow traders with their head office/registered office in an EEA Member State to conduct business across all EEA Member States based on compliance with only home Member State regulations, under the “passport” model.

The “passport” model will not however be available to commodity firms with their head/registered office located outside an EEA Member State or those that are exempt under MiFID (see Section 5 below).

4. When does MiFID come into force?

MiFID came into force on an EEA-wide basis on 1 November 2007.

Not all commodity firms will be initially affected since MiFID allows for limited exemptions. However, the European Commission is currently reviewing these, with final recommendations due in December 2008 at which time they may be removed.

Since 31 January 2007 the UK and other EEA Member States have implemented MiFID into national law. The UK government and the FSA are making the necessary regulatory modifications to conform to the MiFID requirements. The final regulatory modifications will be in place, and will also come into force in EEA wide on 1 November 2007.

The FSA estimates that almost 3000 FSA regulated firms, and close to a hundred specialised commodity firms, will be affected by the MiFID changes. The upfront combined costs for those firms to make the MiFID required changes have been estimated to be more than £1 billion. The ongoing costs are estimated to be more than £100 million per year.
5. How does a commodity trader know if MiFID will apply?

5.1 Location of registered office/head office

If your registered office or head office is located in a Member State within the EEA, MiFID could apply directly to you as explained below.

If your registered office or head office is located outside the EEA but you carry out investment services as defined by MiFID within the EEA you may need to obtain permissions/licences from the appropriate Member State authorities to continue with that business.

Recital 28 of MiFID provides that procedures for the authorisation within the Community of branches of investment firms authorized in third countries will continue to apply.

5.2 Nature of business

You will need to consider the nature of your business in order to ascertain whether it involves carrying out investment services and activities within the EEA as a regular occupation or business on a professional basis.

The FSA determines whether an investment activity is being performed on a professional basis by looking at both the existence of a commercial element and the scale of the relevant activity.

(The meaning of “investment services” is explained in Section 8 below.)

If you are not involved in investment services and activities within the EEA as a regular occupation or business on a professional basis, MiFID will not apply. This means that you will have to ascertain your regulatory status in each EEA jurisdiction in which you carry out your investment business activity on an occasional or non-professional basis and possibly apply for the grant or top up of a local authorisation.
5.3 Exemptions to MiFID

Even if your business falls within MiFID, you may be exempt under one of the exemptions listed.

The exemptions are considered in Section 10 below and it is important that these are considered given that it was envisaged in the MiFID Implementing Regulation (MIR)\(^2\) that the exemptions “could be expected to exclude significant numbers of commercial producers and consumers of energy and other commodities, including energy suppliers, commodity merchants and their subsidiaries” from the scope of MiFID.

However the current exemptions are currently subject to review by the Commission and may be removed (see Section 6 over).

5.4 Impact of MiFID on exemptions at national level

It is important to stress that under the new regime commodity firms whose activity falls within the scope of MiFID will no longer be able to rely on regulatory exemptions at national level if such exemptions are not compatible with MiFID exemptions.

For instance, this is the case of the “with or through” exclusion (Article 16 RAO) in the UK. The FSA has clarified that neither the above mentioned exclusion nor the risk management exclusion under Articles 19 and 23 RAO can be relied upon as the MiFID override applies to dealing in or arranging deals in commodity derivatives by any MiFID investment firm.

UK commodity traders will be unable to rely any longer on exemptions subject to the ISD override (see Article 4(4) RAO) due to the increased scope of financial instruments as between ISD and MiFID which makes the latter (and its overriding effect) applicable to the kind of trading activity carried out by such players.

Commodity traders that qualify as MiFID investment firms will equally be unable to rely any longer on RAO exclusions that fall outside the scope of the ISD override such as the professional activity and employee share schemes exclusion (Articles 67 and 71 RAO). The orientation of the Regulators is to consider such exclusions inapplicable to MiFID investment firms. As for the overseas person exclusion (Article 72 RAO), its non-availability to UK investment firms is still controversial.

5.5 What needs to be done if MiFID does apply?

It is not possible to cover the steps that will need to be done in this brief guide. Obviously any existing passports/permissions should be reviewed and amended or extended if necessary and a full compliance review undertaken in all relevant jurisdictions. We can provide further advice and assistance in this regard.

6. MiFID and the Capital Requirements Directive (‘‘CRD’’)

In addition to MiFID the Capital Requirements Directive (CRD) will also potentially impose further regulatory requirements on commodity firms.

Currently Article 48 of the CRD exempts MiFID specialist commodity firms from having to comply with the capital requirements imposed under the CRD.

However, that exemption is being reviewed by the European Commission\(^3\) along with:

- the exemptions to MiFID\(^4\); and
- the possible extension of the MiFID pre and post trade transparency obligations to classes of financial instruments other than shares (which could include commodity derivatives); and
- an appropriate regime for 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 commodity derivatives or derivatives as defined in MiFID\(^5\); and
- the desirability of amending MiFID to create another category of investment firm whose main business consists exclusively of providing investment services or undertaking activities in relation to commodity derivatives or derivatives as defined in MiFID\(^6\) relating to energy supplies (including electricity, coal, gas and oil).

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\(^4\) Articles 2(i) and (k) of MiFID – see Section 10 below

\(^5\) See derivatives listed in Section 8.1.3 below paragraphs 5-10 inclusive

\(^6\) See derivatives listed in Section 8.1.3 below paragraphs 5-10 inclusive
7. **General overview of MiFID**

MiFID establishes a comprehensive principles-based regime governing the organisational requirements which have to be met by all investment firms and credit institutions providing investment services and activities, regardless of which activities they undertake.

MiFID does three main things. It:

- establishes organisational requirements and customer relations rules for firms who wish to be authorised to conduct investment services and activities including the buying and selling of financial instruments (“investment firms”);
- sets a regulatory framework for exchanges and other markets where the organised trading of financial instruments occurs; and
- enables investment firms and markets to do business across Europe.

As mentioned above MiFID replaces the ISD. The ISD is incorporated into UK law under the Financial Services Market Act 2000 (FSMA) and, in particular, the Regulated Activities Order 2001. However MiFID covers more “financial instruments” than the current RAO. The FSMA regulates business relating to commodities (of any description) insofar as it constitutes buying, selling, advising on or managing: a future over a commodity, an option over precious metal, a contract for differences involving a commodity. The test as to what constitutes a “commodity derivative” under MiFID is wider by including, for instance: options over commodities and forwards namely non-spot physically delivered contracts (See Section 9.6 below on MiFID definition of “spot”). MiFID also adds to the list of relevant financial instruments derivatives on underlyings such as freight, emissions and climatic variables as well as credit derivatives. **MiFID extends the range of commodity derivatives and imposes different standards for deciding which commodities derivatives are covered. The net result is that some previously exempt commodity firms will fall under the remit of MiFID making compliance mandatory.**

In addition, as mentioned above, MiFID combines with the new CRD to impose new financial capital requirements on MiFID firms to which no exemption applies.

The changes imposed by MiFID do not take place all at once. There are “transitional provisions” which allow firms and persons already authorised to do investment business to continue to do so. Under these provisions the following already authorised persons will be deemed to be authorised under MiFID:

1. Investment firms;
2. Regulated markets;
3. Tied agents;
4. Existing communication and trading systems; and
5. Existing categorisation of “professional clients”.

7.1 Passport to more trading opportunities

One of the key changes to be made by MiFID is expanded use of the European “passport”.

Firms and exchanges eligible for the “passport” will be able to offer commodity derivatives services and products across the EEA based only on the regulation of their home state.

They will be able to offer their services (remotely, or by branch or subsidiary) throughout Europe. However, it must be remembered that they will not be permitted to offer services different from those for which they have been authorised in their home state and those persons who are excluded from authorisation under MiFID do not have the same freedom to market their investment services.

This “overnight” expansion of marketing opportunities will challenge both the resources of market participants and that of their home state regulators.

An investment firm that is not subject to MiFID as a result of an exemption can elect to opt into MiFID to obtain the benefit of “passport” rights but will, as a result, become subject to the requirements of MiFID.

Non EEA firms that wish to obtain passport rights will need to consider establishing a subsidiary with a registered office in an EEA Member State which subsidiary will be subject to MiFID.

It must be noted that intermediation is not addressed as such by MiFID. Intermediation is the process whereby, to avoid licensing in an EEA Member State a non-EEA firm provides its services through an EEA licensed and/or “passported” entity. As neither the EU Commission nor the Committee of European Securities Regulators is currently engaged in work on intermediation we do not expect the current European regulatory framework to change as a result of MiFID. This means that overseas firms will need to keep abreast of regulatory developments in each EEA jurisdiction in which they intend to be active.
7.2 Changes to markets

The changes to the ability to offer products covered by MiFID are of importance to all market participants (whether MiFID firms or not). More markets will be available across Europe, subject to an increased level of competition. This offers wider choices and potential extra business for commodity producers, traders and brokers.

Increased business coupled with heavier regulation will mean that markets and traders will require more robust trading and monitoring systems to cope with these opportunities.

These changes will come just in time to help absorb the huge growth in commodities and commodity derivative trading. According to the Bank for International Settlements, there was $2.9 trillion in commodity derivative contracts outstanding in June 2005; by June 2006, that figure had grown to $6.40 trillion and by December 2006 had reached $6.9 trillion.

There has recently been the addition of new exchange traded futures and options products in vital commodities such as uranium, plastics, coal, ethanol, freight and emissions. Large commodity related investments are being made by hedge funds, products are offered related to index funds, and there are new categories of commodity related instruments available including Exchange Traded Funds (ETFs), Exchange Traded Notes (ETNs) and Exchange Traded Commodities (ETCs). It is projected that increased demand from rapidly developing economies such as China and India will drive the need for commodities ever higher.

7.3 MiFID markets

Under MiFID, markets offering multilateral (or multiparty) trading facilities must be organised either as a “regulated market” (RM) or a multilateral trading facility (MTF). Different rules apply to each.

7.3.1 Regulated Markets (RM)

For the first time, commodity derivatives exchanges will be eligible to be EEA regulated markets (RMs).

In the UK, RMs will be incorporated into the existing framework for the current Recognised Investment Exchanges (RIEs). The current Automated Trading Systems will be replaced by the new regime required for MTFs.

Essentially RMs will be much the same as the current RIEs. There will be some modifications to the current RIE rules, but many of the requirements are already in place.
7.3.2 Multilateral Trading Facilities (MTF)

MTFs can be operated by investment firms or RM.

An MTF is defined as a system which brings together multiple third-party buying and selling interests in financial instruments, which operates in accordance with nondiscretionary rules in such a way that results in contracts complying with the provisions of MiFID. As with RM, these can be offered across the EEA with home state authorisation.

In order to comply with MiFID, the FSA will formalise and expand its current regime for Automated Trading Systems. Under MiFID, operating an MTF is a newly regulated investment activity and it will be added as such to the RAO.

It should be noted that with respect to commodity MTFs there is an applicable exemption under Article 48 of the CRD. It covers firms whose main business consists exclusively of investment services or activities in relation to certain derivatives, including commodity related derivatives. This exempts them from the capital requirements of the CRD until 31 December 2010.

7.3.3 Systemic Internalisers (SI)

Another type of trading facility under MiFID is the Systemic Internalisers (SI). An SI is an investment firm which on an organised, frequent, and systemic basis, deals on its own account by executing client orders resulting in the conclusion of transactions in one or more MiFID financial instruments outside a RM or MTF. There is no MiFID requirement to seek home state authorisation to become an SI, but the FSA will require notification if an investment firm becomes or ceases to be an SI.

7.4 Clearing and Settlement

In order to comply with MiFID, both RM and MTF will have to permit users to choose whatever clearing and settlement facility they wish for a transaction as long as links to the facility exist, and the smooth and orderly functioning of the market will not be interrupted.

In order to prepare for these changes various industry associations of European clearing and settlement facilities have adopted a European Code of Conduct for Clearing and Settlement. This emphasises price transparency, access, inter-operability, services unbundling and account separation.

The purpose of this industry generated initiative was to offer potential customers more choices for clearing and settlement and to pre-empt top down regulation in the future.
The operation of these new rules is to be monitored by an ad hoc committee chaired by the European Commission. The proposed code is to be in place and operating by 1 January 2008.

7.5 Market transparency

MiFID requires that markets should have rules that disclose details of current opportunities to trade and require prompt publication of the details of completed transactions, and other market information.

It should be noted that the transparency rules that apply to RMs and MTFs are almost identical, and that such transparency rules also apply to OTC transactions in any products admitted to trading on a RM.

The focus of this requirement is to ensure smooth operation of the equities markets. Therefore, these transparency requirements will not immediately be applicable to MiFID commodities derivative transactions. However, as mentioned in Sub-section 4 above the application of these transparency rules is currently being reviewed by the Commission, and may well be applied to commodities related products in the future.

Despite the lack of formal regulatory requirements for such transparency requirements, some RMs and MTFs demand pre-and post-trade transparency for Exchange Traded Funds, and the FSA is on record as supporting such policies.

8. Scope of MiFID

8.1 MiFID firms

Firms based in the EEA that carry out MiFID investment business are required to have home Member State authorisation in order to continue these activities.

MiFID defines “home Member State” as the Member State in which the registered office of a legal entity is located or, if the legal entity has no registered office and in the case of a natural person, the Member State where the head office is located.

In the UK the “general prohibition” set out in Section 19 of the Financial Services and Markets Act (2000) (FSMA) provides that no person can carry out a regulated activity in the UK, or purport to do so, unless he is an authorised or exempt person. Breach of this prohibition is a criminal offence.
The current position of the FSA is that UK commodity trading firms will not need to vary their status (e.g. Energy Market Participant and Oil Market Participant) to cover MiFID commodity trading if they have the equivalent FSMA permissions. This does not mean that such firms will not need to comply with the regulatory changes introduced by MiFID as explained in Section 12 below.

8.1.1 Investment services

The list of covered “investment services” is found in Annex I, Section A of MiFID. They include:

1. Reception and transmission of orders in relation to financial instruments;
2. Execution of client orders;
3. Dealing on own account;
4. Portfolio management;
5. Investment advice;
6. Underwriting financial instruments and/or placing financial instruments on a firm commitment basis;
7. Placing financial instruments without a firm commitment basis; and
8. Operation of an MTF.

As explained in Section 8.1.3 below it is the definition of financial instruments which is of significance for commodity traders. In particular the definition of financial instruments has been widened beyond that contained in the ISD.

8.1.2 Ancillary services

“Ancillary services” are listed in Annex I, Section B of MiFID. They include:

1. Safekeeping and administration of financial instruments for the account of clients;
2. Granting credits or loans to investors to allow the investor to carry out a transaction in financial instruments involving the lender;
3. Advice on investment related matters such as mergers and acquisitions;
4. Foreign exchange services in connection with investment services;
5. Investment research, financial analysis or other recommendations relating to transactions in financial instruments;
6. Services related to underwriting;
7. Investment services and activities related to certain underlying derivatives – referred to below in bold under number 5, 6, 7 and 10.

8.1.3 Financial instruments

“Financial instruments” are listed in Annex I, Section C of MiFID. They include:

1. Transferable securities;
2. Money-market instruments;
3. Units of collective investment undertakings;
4. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates, or yields or other derivative instruments, financial indices or financial measures which may be settled physically or in cash;
5. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of default or other termination event);
6. Options, futures, swaps and any other derivative contracts relating to commodities that can be physically settled provided they are traded on a RM and/or an MTF;
7. Options, futures, swaps, forwards and any other derivative contracts relating to commodities that can be physically settled not otherwise mentioned in 6 above and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;
8. Derivative instruments for the transfer of credit risk;
9. Financial contracts for differences;
10. Options, futures, swaps, forward rate agreements, and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of default or other termination event) as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this section which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a RM or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

The above definitions relating to commodity derivatives (in particular the definition under number 7 above) have been supplemented in certain respects by the MiFID Implementation Regulation (MIR) (see Section 9.7 below) and in the case of the UK by Perimeter Guidance issued by the FSA\(^7\).

It has been stated by the FSA that physical commodity trading should remain outside the scope of financial regulation and it would appear that most OTC pure physical commodity trading should fall outside the above definitions.

8.2 Clients

A client is defined as any natural or legal person to whom an investment firm provides investment or ancillary services covered by MiFID.

MiFID requires that investment firms categorise their clients as “retail” or “professional”, or as an “eligible counterparty”. MiFID requires different levels of protection for each of these categories with respect to any transactions or activities related to MiFID covered investments.

8.2.1 Retail clients

A retail client is someone who is not a professional client.

\(^7\) [www.fsa.gov.uk/pubs/policy/ps97_05.pdf](http://www.fsa.gov.uk/pubs/policy/ps97_05.pdf)
8.2.2 Professional clients

The definition of a professional client is described in Annex II to MiFID. These are institutions or persons with significant assets and/or significant market experience. They include commodity and commodity derivatives dealers, exchange locals and institutional investors whose main activity is to invest in financial instruments. Before providing any services, the investment firm must inform the professional client that:

1. The client is deemed to be a “professional client”; and
2. Will be treated as such unless the client and the firm agree otherwise.

The client can request to be treated as a “retail” customer and the investment firm may agree to provide a higher level of protection.

Certain clients can also be treated as “professional clients” at the client’s request, which permits waiver of certain Conduct of Business Rules (COB). In order to do this the investment firm must do an adequate assessment of the client’s expertise and knowledge. This must give reasonable assurance, in light of the transactions proposed, that the client can make its own investment decisions and understands the risks. Such assessment must satisfy at a minimum two of the following three criteria:

1. Number of relevant investment transactions carried out within given time periods;
2. Size of client’s financial portfolio; and
3. Client’s competence/know how.

The firm must also give a clear written warning of the protections and investor compensation rights that the client may lose if it is treated as a professional. The client must then state in writing, on a separate document, that it is aware of the consequences of losing these protections.

There are no provisions in MiFID to allow national regulators to disapply or waive the COB requirements to which clients are entitled. Similarly, clients cannot waive these protections either - except for agreeing to be treated as a professional rather than retail client.
8.3 Eligible counterparties

“Eligible counterparties” are organisations such as investment firms, credit institutions, insurance companies and offices of national governments. They can also be persons whose main business is dealing on their own account in commodities and/or commodity derivatives, and those whose sole investment dealing is hedging or dealing on behalf of members of markets where they are guaranteed by clearing members.

The advantages of dealing with eligible counterparties is that investment firms may transact with them without complying with the COB, best execution or client order handling requirements of MiFID. However, before doing any such business, the investment firm must obtain express confirmation that a counterparty agrees to be treated as an eligible counterparty. Also, those who would otherwise be considered eligible counterparties may request treatment as clients and insist on receiving the usual protections afforded by MiFID.

9. Commodity related regulation

Before commenting on the day-to-day operation of the new MiFID regime vis-à-vis commodity traders, it is important to outline how MiFID will impact commodity traders and the applicable exemptions that will enable certain firms to be exempted from the MiFID requirements.

9.1 The current FSA regime

Currently the FSA only has dedicated rules for the Oil Market Participants and Energy Market Participants (OMP and EMP) regimes. It has no rules for commodities and commodities markets. The FSA’s most direct interface with commodities is through the regulation of commodity trading exchanges and clearing houses.

In general, commodity market participants are regulated in a similar way to other UK investment firms. The FSA makes an assessment of the impact of the firm’s business to decide whether they should be “relationship managed” and subject to regular risk assessment under Arrow, or more reactively managed from the FSA’s contact centre.

The FSA conventionally viewed the commodity markets to be of lower risk than financial markets due to the specialist knowledge base of their traditional participants. As non-traditional investors have sought to diversify their investment portfolios through investment in commodity markets, the FSA has reconsidered its approach to regulation.
9.2 MiFID extensions

One change to commodity regulation is the different standards imposed by MiFID for determining which contracts should be regulated. MiFID requires extension of the term “financial instruments” beyond the definition of “investments” in the RAO to cover options on all commodities, and a number of other non-financial products.

9.3 Definition of commodity

The definition of “commodity” under MiFID is “goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity”. Under MiFID “commodity” does not include services or other items that are not goods such as currencies, rights in real estate or other assets that are entirely intangible.

9.4 Commodity passporting

Under MiFID, authorised investment firms will be able to passport investment and ancillary services related to the underlying of a variety of derivatives, including commodity derivatives, as defined in Annex 1 (C) (5), (6), (7), and (10) (see Section 8.1.3 above).

According to Article 28 of the MIR these firms will also be able to passport investment and ancillary services related to trading in spot contracts (otherwise excluded from MiFID) to the extent that such trading is connected to the provision of investment services.

Commodity firms which are exempt from MiFID or have their registered/head office located outside the EEA will not be eligible for “passport” benefits.

9.5 Meaning of “relating to a commodity”

For a commodity or other underlying to be “related” to a derivative contract, there must be a direct link with the contract. For example, an option priced on a commodity future is “related” but a derivative on transportation costs of such commodity is not.
9.6  Spot trading – Exclusion from definition of commodity derivative

With regard to commodities trading regulation, it is always a contentious issue as to whether a transaction is a physical, “spot” trade or a derivative transaction. The distinction is fundamental in the context of MiFID as spot contracts do not fall within the definition of financial instruments. Under Article 38 (2) of the MIR, a “spot” contract is defined as a contract for the sale of a commodity asset or right, under terms of which delivery is scheduled to be made within either two days, or the period generally accepted in the market in question as the standard delivery.

A contract is not “spot”, irrespective of the express terms of the contract, if there is an understanding between the parties that delivery of the underlying will be postponed, or not performed, within one of these periods.

9.7  Commodity derivatives as financial instruments

MIR also provides further guidance on what commodity derivative contracts referred to in MiFID Annex 1 C (7) or (10) (Section 8.1.3 above) should be considered “financial instruments” under MiFID.

Derivative contracts described in MiFID Annex 1 C (7) which are not spot contracts shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if they meet the following criteria:

1. The contract meets one of the following criteria:
   (i) the contract is traded on a non-EEA trading facility that performs a similar function to a RM or MTF;
   (ii) The contract is expressly stated to be traded on or is subject to the rules of a RM, MTF or non-EEA trading facility; or
   (iii) It is expressly stated to be equivalent to a contract traded on a RM, MTF or non-EEA trading facility.

2. The contract is cleared by a clearing house or equivalent or there are arrangements for the payment or provision of a margin in relation to the contract; or

3. The contract is standardised so that, in particular the price, lot, delivery date or other terms are determined primarily by reference to regulatory published prices, standard lots or standard delivery dates.
Derivative contracts described in MiFID Annex 1 C (10) are also subject to certain criteria for determining whether or not they should be considered as having the characteristics of other financial instruments. Derivatives which satisfy one of the following criteria will be Commodity Derivatives for the purposes of MiFID:

1. The contract is settled in cash, or may be, at the option of one of more parties otherwise than by a default or termination event;
2. The contract is traded on a RM or MTF;
3. The contract is traded in a non-EEA country on a market similar to a RM or MTF, and/or is expressly stated to be traded on or subject to the rules of such a facility and/or is expressly stated to be equivalent to a contract traded on such a facility; and the contract is cleared by a clearing house, or equivalent, or is subject to margin payments, and the contract is standardised as to price, lot, delivery terms, etc.

9.8 Energy for “Commercial Purposes” - Exclusion from definition of commodity derivative

Under MIR Article 38 (4), a contract is considered to be for commercial purposes, for the purpose of MiFID Annex 7 C(1) and does not have the characteristics of other derivative financial instruments for the purpose of MiFID Annex 7 C(1) and 8(10), if it is entered into with or by the operator or administrator of an energy transmission grid, an energy balancing mechanism, or a pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time.

9.9 OTC physical forwards

The extent to which OTC Physical Forwards might be caught by MiFID has been an area of concern. This has been due in part to the lack of a clear distinction between or definition of “physical” and “derivative” contracts.
The FSA, in response to a request that their draft perimeter guidance be enhanced to reflect the fact that OTC physical forward transactions intended for delivery did not fall within MiFID, responded by stating that in its view physically settled OTC commodity derivatives might fall within the scope of MiFID in the following limited cases, namely where they:

1. take the form of back-to-back contracts with clients or counterparties equivalent to contracts traded on a RM, MTF or analogous non-EEA trading facility;
2. may be settled in cash at the option of one of the parties, or otherwise than by reason of a default, or termination event; or
3. take the form of a derivative relating to a MiFID commodity derivative, for example, a physically settled OTC commodity derivative relating to a derivative falling within MiFID, Annex I, C 5 (i.e. see Section 8.1.3 above – cash settled commodity derivatives).

9.10 Other commodity derivatives

Under MIR, “other derivative financial instruments” can include derivative contracts relating to:

1. Telecommunications bandwidth;
2. Commodity storage capacity;
3. Transmission or transportation capacity relating to commodities whether cable, pipeline or other means;
4. An allowance, credit, permit, right, or similar asset, which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;
5. A geological, environmental or other physical variable;
6. Any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred;
7. An index or measure related to the price or value of, or volume of, transactions in any right, service or obligation.

9.11 Commodity derivative transaction reports

In conformity with the requirements of MiFID, the UK will require reports to be made about commodity derivative contracts (as well as interest rate and foreign exchange derivatives) that are traded on RMs. Reporting of the transaction will be required whether or not the transaction occurred on a RM.
The FSA is exploring arrangements with the commodity and commodity derivative trading exchanges in the UK to receive electronic reports, and the FSA is seeking to make arrangements with exchanges in other Member States to obtain the same.

It is not the FSA’s present intention to require the reporting of OTC commodity derivatives.

### 9.12 Market abuse

The provisions of the market abuse directive, as implemented in the UK, cover commodity futures and options traded on regulated markets, and their issuers.

Market participants are subject to prohibitions against the use of inside information related to those derivatives and other market misconduct. To date, market abuse regulation, as it relates to spot trading, has not been harmonised at an EU level. However, this will be looked at in the future.

### 9.13 US Part 30 exemption

US law currently restricts the ability of non-US firms to trade on behalf of US customers on non-US futures and options exchanges. To overcome this, the FSA currently sponsors an exemption to permit such transactions.

Under the exemption, a US client cannot opt out of “client money” regulations. Some LME participants are concerned that the Part 30 exemption will be affected by changes to client money regulations under MiFID. The FSA has promised to work with the CFTC on this issue, and there will be further information about it later.

### 9.14 More regulatory changes?

The provisions required by MiFID and CRD profoundly affect the regulation of recognised bodies and investment firms. Therefore the FSA is making substantial changes to its Conduct of Business (COB) rules and Systems and Controls requirements (SYSC).

The FSA has recognised that MiFID makes many changes to the way commodity markets are operated throughout Europe. In order to keep abreast of the concerns of market participants, the FSA has instituted a program of informal visits to market participants to expand its knowledge of the commodity markets. These are in addition to its formal supervision regime and are intended to expand the FSA’s understanding of how the markets currently work and how they should work in the future.
10. **Exemptions to MiFID**

Article 2 of MiFID provides 13 exemptions, a number of which are of significant interest to those involved in commodity derivatives trading.

This guide will mention only the most broadly relevant to commodity and commodity derivatives trading.

10.1 **Relevant exemptions to commodity traders**

Article 2 (1) (b) creates an exemption for persons providing investment services exclusively for their parent’s undertakings, their subsidiaries, or for other subsidiaries of their parent’s undertakings.

Article 2 (1) (d) offers an exemption for persons who do not provide investment services or activities other than dealing on their own account, unless they are market makers or deal on their own account outside a RM or MTF on an organised, frequent and systemic basis by providing a system accessible to third parties in order to engage in dealings with them.

Article 2 (1) (i) creates an exemption for persons dealing on their own account in financial instruments, or providing investment services in commodity derivatives or derivative contracts included in Annex I, Section C 10 (see Section 8.1.3 above) to clients of their main business (when considered on a group basis) and, that business is not the provision of “investment services” or “banking services”.

Article 2 (1) (k) creates an exemption for persons whose main business is dealing on their own account in commodities and/or commodity derivatives. But that exemption shall not apply if those persons are part of a group whose main business is the provision of other “investment services” or “banking services”.

Article 2 (1) (l) creates an exemption for firms which provide investment services and/or perform investment activities consisting solely of dealing on their own accounts on markets in financial futures, options, or other derivatives, and on cash markets for the sole purpose of hedging positions on derivatives markets, or which deal for the accounts of other members of those markets, or make prices for them, and which are guaranteed by clearing members of the same markets where the clearing members assume responsibility for ensuring the performance of contracts entered into by such firms.

As is stated above, it was envisaged that many commodity traders will fall within one or more of the above exemptions thereby initially avoiding becoming subject to MiFID.
10.2 FSA Guidance

The Commission is expected to provide further definition of such terms as “ancillary” or “incidental” in connection with these exemptions. However, the FSA has already offered some views on the subject.

According to the FSA, relevant factors in determining the “main business” of an enterprise are likely to include: turnover, profit, capital employed, numbers of employees and time spent by employees when compared with a firm or groups of their operations or business lines.

In the FSA’s view, an activity will be “ancillary” if it is directly related and subordinate to a group’s main business. For example, buying and selling commodity derivatives for purposes of limiting risk to a main business would qualify as “ancillary”, but most “speculative” dealing would not.

The FSA’s definition of “dealing on own account” is trading against proprietary capital resulting in conclusion of transactions in one or more MiFID financial instruments.

10.3 Future development

All of the MiFID exemptions will be reviewed in the future and the Commission is due to complete its consideration by the end of December 2008. At that time there will probably be a decision about whether the exemptions should be maintained, expanded or reduced.

Commodity firms may wish to involve themselves in the lobbying groups that have been formed within the commodities industry.

11. Business obligations under MiFID

Any firm to which MiFID applies needs to be aware of the various business obligations required by MiFID.

These obligations are set out in staggering detail in the FSA Handbook of Rules and Guidance (now being extensively revised to implement MiFID).

They include the following:

1. The persons who effectively direct the business of an investment firm are required to be of good repute and sufficiently experienced to guarantee the sound and prudent management of the investment firm;
2. An investment firm must act honestly, fairly and professionally, in accordance with the best interests of its clients when providing its clients with investment or ancillary services;

3. All information provided by investment firms to clients, or potential clients, must be fair, clear and not misleading. Marketing communications should be identified as such;

4. Appropriate information shall be provided to clients about the firm and its services, different financial instruments and investment strategies (including warnings of risks associated with the instruments and strategies), execution venues, costs and charges.

5. The above information must be given in a form that enables clients to be able to understand the nature of the risks involved, allowing them to make informed investment decisions.

11.1 Transaction reporting

Under MiFID, all transactions and instruments admitted to trading on a RM are to be reported, including commodity derivative contracts. The reports are required to be made to the local regulator of the firm, not the regulator of the market. These reports must be made whether or not the transactions were carried out on a RM. They should detail the names and numbers of instruments bought and sold, quantities, dates and times of execution, transaction prices and means of identifying the firms concerned.

Those investment firms and market operators who operate a MTF must monitor compliance with the rules of the MTF, and other legal obligations to both identify rule breaches and potential market abuse and other market misconduct. Firms or market operators are required to report any significant breaches that may involve market abuse to the appropriate competent authority and, provide full assistance in investigating and prosecuting such misconduct.

11.2 Client order handling

Firms are required to have procedures and arrangements for the prompt, fair and expeditious execution of client orders relative to other client orders or the trading interests of the firm.
11.3 Best execution

Under MiFID, investment firms have an obligation to execute client orders on terms most favourable for clients. This applies to all MiFID financial instruments and is required of firms that owe contractual or agency obligations to a client.

In order to comply with MiFID, an investment firm must have a written order execution policy for each class of instruments, which contains information on:

1. Different venues where the investment firm executes its client orders, including those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders; and

2. The factors affecting the choice of execution venue.

Investment firms are required to take all reasonable steps to obtain the best possible execution for clients regarding price, cost, speed, likelihood of execution and settlement, size, nature, or any other relevant consideration. However, if the client gives specific instructions, the firm must follow the specific instruction.

The firm must obtain the client’s consent to its execution policy prior to the completion of any transactions. The firm must also obtain the client’s prior consent to the execution of any orders outside a RM or MTF.

A firm will have to assess the execution venues it uses on at least a yearly basis, and consider other execution venues. It must monitor the effectiveness of its execution arrangements, and, if requested, show that a client’s order has been executed in line with the firm’s execution policy.

11.4 Conflicts of interest

Under MiFID, an investment firm is required to maintain and operate effective arrangements that comply with taking all reasonable steps to prevent conflicts of interest from adversely affecting the interests of its clients. Firms will have to identify any conflicts that may arise in the course of providing investment or ancillary services between themselves (including their managers, employees or persons directly or indirectly linked to them by control) and their clients, and between one client and another.

When such arrangements are not sufficient to ensure, with reasonable confidence, that damage to client interests will be prevented, the firm is required to clearly disclose to the client the general nature or source of the conflict before undertaking any business on the client’s behalf.
11.5  Data protection
The right of privacy of all persons with respect to data processing must be protected in conformity with European legislation and regulations on data protection.

11.6  Outsourcing
MiFID requires that outsourcing must not impair the quality of the firm’s compliance with all of its obligations under MiFID.

11.7  Custodianship
When holding any client financial instruments or funds, an investment firm must make adequate arrangements to safeguard the client’s ownership rights, especially in the event of the firm’s insolvency. The firm cannot use a client’s instruments for its own account except (but only in the case of financial instruments - not funds) with the client’s express consent.

11.8  Suitability
When providing investment advice or portfolio management, an investment firm must obtain necessary information about the client’s, or potential client’s, knowledge, investment experience, financial situation, and investment objectives. The firm must recommend investment services and financial instruments that are suitable, and the firm must warn clients when a product or service is unsuitable, or when a client has failed to provide sufficient information to determine suitability.

11.9  Record-keeping
Investment firms are required to maintain records for at least five years of all relevant data relating to transactions and financial instruments either on their own account or on behalf of clients. This includes all information and details of client identity as required by the Money Laundering Directive.

Firms must keep records that document the information given to a client about the rights and obligations of the parties and other terms on which the firm will provide services to the client.

Information about rights and duties may be incorporated by reference to other documents or legal texts.
11.10 **Client reports**

The firm must supply the client with adequate reports of the services provided including all costs associated with transactions and services.

11.11 **Instructions from other firms**

If a firm receives instructions for an investment or other service, on behalf of a client, from another investment firm, the firm receiving instructions is entitled to rely on the client information supplied by the other firm. The firm sending the instructions is responsible for the accuracy and completeness of the instructions, but the firm receiving instructions is responsible for concluding the transactions or services requested.

11.12 **Tied agents**

Firms can appoint tied agents, however they must be of good repute and possess appropriate knowledge to accurately communicate relevant information to clients. Firms are responsible for monitoring agents’ compliance and, the firm remains responsible for the acts or omissions of agents.

11.13 **Investor Compensation Scheme**

An investment firm is required to belong to an adequate investor compensation scheme. The FSA will maintain the current Financial Services Compensation Scheme.

12. **OMP and EMP Regulation**

12.1 **Energy Market Participants**

Energy Market Participants (EMPs) and Oil Market Participants (OMPs) are currently subject to special regulatory arrangements by the FSA to reflect “prudential” treatment of such firms. Under these regimes, FSA COB requirements apply, but not for businesses with “market counterparties”, which, in fact, constitute a significant portion of the activity in such markets.

An EMP is a firm whose permission does not cover any investment business except energy market activity, and which is not a professional firm or another type of investment firm such as a bank or mortgage lender, and which is not an Oil Market Participant.

Energy market activity is any regulated activity related to an energy investment or energy, which involves executing own account transactions on any recognised investment
exchange or designated investment exchange or, if not on such exchanges, is performed in connection with or for persons who are not private customers. It can also include establishing operating or winding up a collective investment scheme which is an energy collective investment scheme in which private customers do not participate.

12.2 Oil Market Participants

OMPs are subject to similar requirements except their permission limits them to investment business related to oil market activity.

Oil market activity is regulated activity related to oil investment or oil, which involves execution of own account transactions on recognised investment exchanges or designated investment exchanges or, if not, is performed in connection with or for persons who are not individuals. It can also include establishing, operating or winding up a collective investment scheme which is an oil collective investment scheme in which individuals do not participate.

There are also various special capital and reporting requirements for EMPs and OMPs.

12.3 MiFID and EMP/OMPs

The FSA points out that under MiFID, there is no scope for a regulator to disapply or make concessions from or modifications to the Conduct of Business rules required to implement MiFID. However, such rules only apply to MiFID business. As far as the FSA is concerned, its disapplications of OMP and EMP business will continue with respect to non-MiFID activities.

Any MiFID firms conducting energy or oil market activity with “professional” or “retail” clients will have to comply with the FSA’s new Conduct of Business provisions implementing MiFID requirements. However, many of these provisions will not apply to transactions with eligible counterparties.

Another example of why MiFID may not apply to many energy related transactions is found in MIR Section 22 which states that the exemptions in MiFID relating to commodity derivatives could be expected to exclude “significant numbers” of commercial producers and consumers of energy and other commodities, including energy suppliers, commodity merchants and their subsidiaries. Therefore, such participants would not be required to apply MIR tests to determine if their contracts are financial instruments.
13. Conclusions

It is obvious that the impact of MiFID on the commodity business will be wider than many market participants expect. MiFID is no less than a comprehensive financial services act for the EU. It covers almost every aspect of the investment business and brings much of the commodity business under its coverage.

Although there are currently numerous exemptions that may allow firms to avoid the requirements of MiFID, these are currently being reviewed in order to determine whether they should be continued, expanded or removed in the near future.

The European Commission is due to issue a report before the end of 2008 expressing a view as to which commodities firms, activities and instruments should be subject to EU financial market regulation, and whether existing regulation will need to be changed to adequately cover commodities and commodity derivatives.

An issue being discussed is whether the pre-and post-trade transparency obligations that currently apply to equity transactions should be extended to other classes of financial instruments including commodity derivatives.

On these issues, the Commission claims to have no preconceived ideas. However, any changes will have a significant effect on a large number of commodity market participants.
## Appendix I

### MiFID “Commodity” Financial Instruments

<table>
<thead>
<tr>
<th></th>
<th>Cash settled*</th>
<th>Physically settled</th>
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<tbody>
<tr>
<td><strong>OTC</strong></td>
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<tr>
<td>Options, swaps, forward rate agreements and any other derivative contracts relating to a “commodity”(^1)</td>
<td>Options, futures (sic), swaps any other derivative contracts relating to a “commodity” and “having characteristics of other derivative financial instruments”(^3) unless they are for “commercial purposes”(^4) and unless they are “spot”(^5)</td>
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<tr>
<td>Options, swaps, forward rate agreements and any other derivative contracts relating to a C10 underlying(^2)</td>
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<tr>
<td><strong>Exchange Traded</strong>(^*)**</td>
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<tr>
<td>Options, futures and any other derivative contracts relating to a “commodity”</td>
<td>Options, futures, swaps and any other derivative relating to a “commodity”</td>
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<tr>
<td>Options, futures and any other derivative contracts relating to a C10 underlying</td>
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* Absolutely or at one party’s option (other than by reason of default or other termination event).
\(^*\) Traded on a Regulated Market or Multilateral Trading Facility as defined by MiFID.

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1 “Goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity”.

2 “Climatic variables, freight rates, emission allowances, inflation rates or other economic statistics”.

3 “Having regard to whether, inter alia, they are cleared and settled through recognized clearing houses or are subject to regular margin calls”.

4 A contract “entered into with or by the operator or administrator of an energy transmission grid, an energy balancing mechanism, or a pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time”. A contract that meets the criteria listed in MIR Art 38(1) (i.e. traded through exchange etc.) cannot be considered a contract entered for commercial purposes.

5 A contract for the sale of a commodity asset or right, under terms of which, delivery is scheduled to be made within either two days, or the period generally accepted in the market in question as the standard delivery. However, a contract is not a spot contract, if, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within the period mentioned above.
Appendix II

Is the contract a spot contract?¹

No

Is the contract for commercial purposes?

No

Does the contract entail a physical delivery?

No

Does the contract have a commodity as underlying?²

Yes

Are the following conditions met:

(i) contract takes the form of a back-to-back contract equivalent to contract traded on a RM/MTF or analogous non EEA trading facility; or

(ii) contract may be settled in cash at the option of one of the parties otherwise than by reason of default or termination event; or

(iii) contract takes the form of a derivative relating to a MiFID commodity derivative, for instance a physically settled OTC forward transaction with the contract price based on a futures contract.

Yes

It IS a Commodity Derivative

No

Are the following conditions met:

(i) contract traded on non EEA trading facility that performs an analogous function to a RM/MTF; or

(ii) contract expressly stated to be traded on, or is subject to the rules of a RM/MTF or a non EEA trading facility; or

(iii) contract expressly stated to be equivalent to a contract traded on a regulated market, MTF or third country trading facility; and

(iv) contract cleared by a clearing house or equivalent or there are arrangements for the payment or provision of margin in relation to the contract; and

(v) contract is standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.

No

It is NOT a Commodity Derivative

¹ See definitions of “spot” and “for commercial purposes” in Appendix I.

² i.e. a commodity as opposed to a C10 underlying, such as climate, freight, emissions, economic statistics, bandwidth, commodity storage, transportation capacity, renewable resource credits etc.
14. **Further advice and assistance**

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