

EU securities legislation for commodity derivatives business



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What is CESR?

- Committee of European Securities Regulators
- 29 Members from the EU and EEA
- Established in 2001 by the Decision of the European Commission
- Background: Lamfalussy Report that introduced a four level approach to the development of EU securities legislation
- Independent Committee regrouping senior representatives from national public authorities competent in the field of securities regulation



What is CESR?

- CESR's role
 - Improve co-ordination among EEA securities regulators
 - Act as an advisory group to the European Commission
 - Ensure a consistent and timely day-to-day implementation of EU legislation in the Member States
- Commission proposal to transform CESR into European Securities and Markets Authority (ESMA)



Contents

- MiFID and commodity derivatives
 - Commodity derivatives covered by MiFID
 - Admission to trading on a regulated market
 - Exemptions from the scope of MiFID for commodity derivatives firms
 - Transparency of trading and transaction reporting
- MAD and commodity derivatives
 - Commodity derivatives covered by MAD
 - Prohibition of market abuse
 - Disclosure of inside information



Commodity derivatives covered by MiFID

- MiFID (Markets in Financial Instruments Directive) regulates the provision of investment services and organisation of trading in financial instruments
- Commodity derivatives are financial instruments covered by MiFID
 - Commodity = any 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
 - “Derivative” not defined in MiFID
 - The expression “options, futures, swaps, forward rate agreements and any other derivative contracts” used



Commodity derivatives covered by MiFID

- Types of commodity derivatives covered by MiFID:
 - 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;
 - Derivative contracts relating to commodities that can be physically settled provided that they are traded on a regulated market (RM) and/or a multilateral trading facility (MTF); and
 - Derivative contracts relating to commodities, that can be physically settled not otherwise mentioned above and not being for commercial purposes, which have the characteristics of other derivative financial instruments (e.g. use of clearing houses or regular margin calls)



Commodity derivatives covered by MiFID

- According to the advice of CESR and CEBS (Committee of European Banking Supervisors) to the Commission there is no need to revise the definition of commodity derivatives in MiFID
 - Existing definition assessed to be sufficiently clear by market participants
 - Limited evidence of regulatory arbitrage



Admission to trading of commodity derivatives on an RM

- Clear and transparent rules regarding the admission to trading
- The rules ensure that the financial instruments are capable of being traded in a fair, orderly and efficient manner
- The design of the derivative contract allows for its orderly pricing and the existence of effective settlement conditions
- Additional, more detailed requirements for derivatives
 - The specificities of commodity derivatives have been taken into account in these more detailed requirements



Exemptions from the scope of MiFID

- Persons dealing on own account in financial instruments or providing investment services in commodity derivatives to the clients of their main business, as an ancillary activity to the group's main business (which is not investment or banking services)
- Persons whose main business consists of dealing on own account in commodities and/or commodity derivatives, except if they are part of a group the main business of which is the provision of investment or banking services



Exemptions from the scope of MiFID

- CESR/CEBS advice to the Commission:
 - Need to maintain, but modify the current exemptions
 - Revised exemptions for firms that are not otherwise providing investment or banking services:
 - Incidental provision of investment services in commodity derivatives (connected to the provision of non-financial services + business relationship)
 - Own account dealing in commodity derivatives (not with unsophisticated clients nor to execute client orders)



Transparency of trading in commodity derivatives markets

- No pre- and post-trade transparency obligations for (commodity) derivatives trading in MiFID
 - CESR/ERGEG (European Regulators' Group for Electricity and Gas) advice to the Commission proposed that RMs and MTFs publish post-trade information on standardised electricity and gas derivatives (same proposal for supply contracts traded in the spot markets)
- Commission Communication 20 October 2009:
 - Commission to propose transparency requirements for all derivative markets as part of the MiFID review of 2010 and for spot markets as part of a market integrity package related to electricity and gas markets



Commodity derivatives and MiFID's market integrity provisions

- Transaction reporting
 - Firms obliged to report details of transactions in any financial instrument admitted to trading on an RM to the competent authority
 - For commodity derivatives, the obligation implemented in practice by requiring the regulated markets to provide transaction reports to their home Member State competent authority
- Commission Communication 20 October 2009:
 - Commission to amend MiFID to require transaction and position reporting to be developed in conjunction with CCPs and trade repositories
 - Commission to propose rules to give regulators the possibility to set position limits in MiFID



Commodity derivatives covered by MAD

- Market Abuse Directive (MAD) applies to financial instruments admitted to trading on an RM, irrespective of where the transaction takes place
 - Insider dealing prohibition and prohibition to disclose inside information also apply to any financial instrument whose value depends on a financial instrument admitted to trading on an RM
 - Market manipulation prohibition has the “standard” scope
- Problems highlighted by CESR/ERGEG:
 - Physical markets not covered at all
 - Not all derivatives covered (those admitted to trading on an MTF, pure OTC)



Obligation to disclose inside information under MAD

- Issuers of financial instruments have to inform the public as soon as possible of inside information which directly concerns the said issuer
- Inside information in relation to commodity derivatives:
 - is information of a precise nature;
 - has not been made public;
 - relates, directly or indirectly, to such derivative(s);
and
 - which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets



Obligation to disclose inside information under MAD

- Problems highlighted by CESR/ERGEG:
 - obligation to disclose inside information in MAD applies to issuers \Rightarrow not relevant for derivatives markets
 - the information the users of energy markets can expect is not sufficiently clearly defined



MAD and commodity derivatives

- Solutions proposed by CESR/ERGEG:
 - Implementation of disclosure obligations in the energy sector legislation that oblige the relevant entities (e.g. generators, suppliers, TSOs) to disclose information likely to influence physical and/or derivatives markets
 - Development of a tailor-made market abuse framework in the energy sector legislation for all electricity and gas products not covered by MAD



Conclusions

- EU securities legislation broadly appropriate for commodity derivatives markets
- But some changes needed:
 - Adjustments to the scope of firms covered by MiFID (CESR/CEBS)
 - Need to increase transparency of trading on energy markets (CESR/ERGEG)
 - Transaction and position reporting to be further developed (Commission)
 - Need to create energy sector specific legislation to implement appropriate disclosure obligations and prevent market abuse in the energy markets (CESR/ERGEG)