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UK Discussion Paper on the Commission's review of the Financial Regulatory Framework for Commodity and Exotic Derivatives

Dear Jenny

The City of London Law Society is the local Law Society of the City of London. Members of the Regulatory Committee advise a wide range of firms in the financial markets, including banks, brokers, investment advisors, investment managers, custodians, energy firms, private equity and other specialist fund managers as well as market infrastructure providers such as trading, clearing and settlement systems.

We are writing to comment on questions 16-18 in the Discussion Paper (Proposal to remove the exemption in Article 2.1(k) of MiFID). Members of the Committee advise a large number of oil and other energy firms and their trading subsidiaries on the application of the exemptions in Article 2.1 of MiFID.

Summary

The Regulatory Committee does not take a view on the general policy considerations raised in the Paper on the regulation of the commodity derivatives market, instead our comments are limited to the technical question raised in Q18, namely if Article 2.1(k) was removed, would any firms be brought within the MiFID scope, and the wider questions raised in Q14-18 about the interaction of Article 2.1(d), (i) and (k) on energy companies which deal as principal. Specifically, in our experience in advising energy companies, there are firms which would be brought within the MiFID scope if Article 2.1(k) were removed. In part this is because the European Commission and the FSA have, in their recently published guidance on the scope of the alternative exemptions in Article 2.1(d) and (i), restricted the scope of those exemptions resulting in enhanced reliance on Article 2.1(k).

Questions 14-18-Comments

By way of background, as you may be aware, a number of energy companies structure their operations in energy derivatives so that the company(ies) which contracts as principal in energy derivatives is/are the main, or a significant, operating company in the group. Such a company will,

because it holds most or a significant proportion of the operating assets in the group, have a high counterparty credit rating. In order that such a company should not require authorisation under the FSMA, bearing in mind that its activities are principally energy/production and/or supply, use is sometimes made of the exemptions in Articles 16 (dealing in contractually based investments) and 19 (risk management) of the FSMA 2000 (Regulated Activities Order 2001) ("RAO"). In practice, because of the technical requirements of article 19, commonly all transactions will be effected through an authorised intermediary, making use of the exemption in Article 16. When dealing in OTC markets, the authorised intermediary is often a group company, which deals as agent for the group company(ies) which deal as principal.

Articles 16 and 19 are, however, both subject to Article 4(4) RAO, the "MiFID override". It is important to the unauthorised principal company, therefore, that a relevant exemption in respect of its dealing as principal/dealing on own account activities arises under Article 2 of MiFID.

The scope of the exemptions in Article 2.1(d) and (i), the alternatives to Article 2.1(k), have, however, both been restricted by guidance from the Commission (in the case of article 2.1(d)) and from the Financial Services Authority (in the case of article 2.1(i)).

In the case of Article 2.1(d) the Commission in its Questions and Answers with respect to MiFID (question no. 40 answered 10/4/2007) states that the exemption should be regarded as a very restricted one. It states "It (the exemption) does not include marketmakers (a notion which per se is quite broad) and other firms which deal on own account in an organised, frequent and systematic manner" (our underlining). Dealing in energy derivatives is often just an alternative to dealing in the physical commodity itself, and is, therefore, in the case of a large group, likely to be frequent and carried on side by side with physical trading of bulk product. An energy company which maintains an active trading desk is, on the Commission's restrictive interpretation of Article 2.1(d), unlikely to be able to make use of the 2.1(d) exemption.

The obvious alternative to Article 2.1(d) is the exemption in Article 2.1(i) which exempts, inter alia, dealing as principle in relation to commodity derivatives provided the main business of the group concerned is dealing on own account in commodities and/or commodity derivatives and it is not part of an investment services or banking group, and provided further that the activity is "ancillary" to the group's main business. While the interpretation of the term "ancillary" is one of the items which the European Commission has asked CEBS/CESR to consider pursuant to the joint request of 21 December 2007 (question 6(c)(i)), the FSA has itself in the meantime issued guidance in Q45 in PERG 13.5 of its rulebook. This states that for an activity to be ancillary, it must be both directly related and subordinate to the main business of the group. In addition though, the FSA states that where a commodity producer deals on own account for "speculative purposes", it is unlikely that this will be ancillary to the main business in the case of article 2.1(i). Instead it suggests firms may have to rely on Article 2.1(k).

Although members of the Committee have considerable doubts concerning the advice of the FSA, in particular what it says about speculative trading seems to unnecessarily narrow the ambit of Article 2.1(i), (and also as to the Commission's interpretation of Article 2.1(d)) it is difficult for them to advise their clients to ignore it. Consequently, where energy firms actively deal as principal in energy derivatives as part of a trading activity and individual deals cannot be linked to hedging, firms have been advised that they instead can rely on article 2.1(k). (That said, the exemption in article 2.1(k) has its limitations, unlike that in article 2.1(i), it only applies to commodity derivatives and therefore its application in the case of some of the exotic derivatives in paragraph 10 of section C of annex 1 of the Directive is unclear, which may require firms to rely on

a combination of 2.1(i) (non-speculative trading in exotic derivatives) and 2.1(k) (trading in commodity derivatives).)

To conclude, failing a widening of the interpretation of Article 2.1(d) and, especially, (i); if the exemption in article 2.1(k) were removed, energy companies which deal as principal would be severely curtailed in the amount of trading they can do unless they obtain authorisation.

If you have any queries on this letter please contact Margaret Chamberlain.

Yours faithfully

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