REPORT OF THE OPEN HEARING ON
MiFID COMMODITY DERIVATIVES REVIEW

Brussels, September 25, 2008

On September 25, 2008 in Brussels between 10h and 16h, the European Commission held an open hearing on the review of the regulatory exemptions granted to specialist commodity derivative firms ex art. 2(1)(i) and (k) of the Markets in Financial Instruments Directive (MiFID). The debate took place after the Commission issued a joint mandate for advice to the Committee of European Securities Regulators (CESR) and the Committee of Banking Supervisors (CEBS) on December 21, 2006. CESR-CEBS held two public hearings and put out a consultation paper in May 2008. They plan to publish their final advice to the Commission some time in October 2008. The discussions considered also the regulatory developments in the US where the Commodity Futures Trading Commission (CFTC) just published a report in September 2008 on the actors in commodity derivatives markets. The CFTC proposed amendments to the current US regulation aimed at increasing market transparency and monitoring possible market manipulation.

The review saw contrasting views concerning transparency, capital requirements, client categorisation, market abuse and the MiFID exemptions. Concerns about the lack of transparency in commodity markets, especially electricity and gas markets, were widely shared, but the details and implementation of measures aimed at improving it were controversial. Transaction reporting v. record-keeping; pre-trade v. post-trade transparency, spot v. derivative markets, regulation v. voluntary codes were the main areas of contention. As far as capital requirements are concerned, commodity firms lobbied for qualitative risk management while banks called for full regulation of specialist commodity firms. Some firms voiced concerns about the present client categorisation regime and the criteria to establish when a customer needs protection. Some speakers considered the implementation of a market abuse scheme tailored on commodities to be excessive and suggested to rely on transparency and market monitoring by exchanges to obviate to the problem. On the contrary, European energy regulators called for a full-fledged market abuse regime. Finally, some deemed the MiFID exemptions extremely unclear.

Emil Paulis, Director of Financial Services Policy and Financial Markets, DG Internal Market and Services, European Commission, opened the discussion with some background information about the exemptions. Mr Paulis said that the MiFID exemptions stem from the professional nature of commodity derivatives markets. He claimed the important issues to look at are whether there is inconsistency in the application of the exemptions and what the specificities of commodity markets are. Mr Paulis asked if the rationale behind the MiFID exemptions to specialist commodity derivatives firms is still valid today. He also argued that granting exemptions to one sector may result in other sectors lobbying to be outside the scope of

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regulation. Referring to the findings of the Commission's Sector Inquiry into the electricity and gas markets, Mr Paulis said excessive market concentration, lack of liquidity and mistrust in the pricing mechanisms convinced the Commission to act to further liberalise the sector. The 3rd Energy Package proposed aims at injecting more competition and transparency in the electricity and gas markets.

Eija Holttinen, Acting Director, Markets and Intermediaries, CESR, summarised the advice of CESR on Commodities to the European Commission. She first recapitulated the questions the Commission asked to CESR-CEBS in its mandate. Mrs Holttinen said CESR-CEBS evaluated three main areas in their advice: evaluation of MiFID requirements with respect to specialist commodity derivatives firms (pre- and post-trade transparency, transaction reporting, organisational requirements, conduct of business rules and client categorisation); evaluation of definition of commodity/exotic derivatives; nature and scope of the MiFID exemptions. Mrs Holttinen said legal obligations on pre- and post-transparency and transaction reporting are unnecessary. Moreover, she claimed that during consultations no need emerged to adapt or change organisational requirements and conduct of business rules contained in MiFID. The CESR-CEBS advice proposes to change client categorisation rule to better fit commodity derivatives firms, Mrs Holttinen stated. Furthermore, she said the definition of commodity and exotic derivatives need not to be altered. Overall, Mrs Holttinen suggested maintaining but modifying the MiFID exemptions in art. 2(1)(i) and (k) by allowing exempt firms to opt in; by granting the possibility to combine exemptions; and by adopting broad principles to exempt firms engaging in incidental provision of investment services in commodity derivatives that are not banks or professional investment services firms.

Gerald Dillenburg, Senior Advisor, Bundesbank, CEBS, focused his intervention on prudential regulation applicable to commodity firms. Mr Dillenburg claimed that no evidence emerged that energy-only firms generate different risks from other commodity firms and therefore no different treatment should be adopted. A majority of members of the CESR-CEBS Joint Task Force on Commodities retained the full application of the Capital Requirements Directive (CRD) to specialist commodity firms to be disproportionate in light of the limited systemic risk posed. Mr Dillenburg argued that the maturity ladder approach within the CRD is not suitable for the business model of commodity firms. Mr Dillenburg advanced two regulatory options to set up an appropriate prudential regime to commodity firms: (1) adequate financial resources requirements and qualitative risk management (2) full application of CRD. He concluded noting that three countries led by the UK favour option 1 and other three countries led by Germany prefer option 2, but a majority of European states is unsure on the preferred regulatory outcome.

Karl-Peter Horstmann, RWE Supply and Trading and Chair of Subgroup, European Securities Markets Experts Group (ESME), summarised the advice of ESME to the Commission. Mr Horstmann argued that since commodity business is a specific activity, it requires specially-tailored rules. Very diverse actors compose commodity markets: distribution companies, municipal utilities, financial firms, industrial consumers and others. The presence of retail investors is negligible and therefore rules to protect investors are unnecessary. The products have very diverse characteristics, and the trading venues are multiple. Moreover, the purposes of market activity are physical delivery, procurement and risk management. Hence, commodity markets are different from traditional financial markets, Mr Horstmann claimed. He also said commodity business does not pose any threat to financial stability and a qualitative approach to capital requirements is strongly preferred. Mr Horstmann argued that the current level of trade transparency is adequate. However, he called for greater transparency of fundamental data such as data on the use of infrastructure and on holdings of physical assets. Furthermore, multilateral trading facilities and brokers should have a legal obligation to publish information regarding transactions concluded, Mr Horstmann stated. He advocated for a tailor-made regime along the

lines of the CESR-European Regulators' Group for Electricity and Gas (ERGEG) advice rather than an extension of the Market Abuse Directive (MAD) to commodity markets. ESME recommends the replacement of the art. 2(1)(i) and (k) with a single exemption targeted at professionals dealing on own account in wholesale markets, Mr Horstmann said. Finally, Mr Horstmann claimed that the rules concerning record-keeping should be principle-based rather than prescriptive and that it is not necessary to require a standardised format to record information.

Johannes Kindler, Vice-President, Bundesnetzagentur and Vice-President, ERGEG, presented the findings of the CESR-ERGEG Joint Group on electricity and gas markets pursuant the Commission's call for advice issued on December 21, 2007. Mr Kindler affirmed that the presence of investment firms in the supply of electricity and gas in Europe is small. He claimed that over-the-counter (OTC) markets are unregulated, whereas derivatives and physical markets are supervised by securities and energy regulators respectively. A number of countries have adopted post-trade legal transparency requirements, some have embraced pre-trade transparency obligations, but none has put in place rules for OTC markets, Mr Kindler said. He also argued that the MAD regime does not apply well to electricity and gas markets, also considering that the regime does not cover either OTC markets or transactions operated on multilateral trading facilities. CESR and ERGEG suggest a tailor-made market abuse regime for electricity and gas markets. Mr Kindler said that although some actors were weary of regulation because they saw no evidence of market abuse, transparency enjoyed broad support amongst market participants. ERGEG favours strong regulation, even though the options have to be carefully reviewed, Mr Kindler declared.

Maria Velentza, Head of Unit, Securities Markets, DG Internal Market and Services, European Commission summed up the issues to deal with when looking at the MiFID commodity review and the 3rd Energy Package. Mrs. Velentza affirmed that the relevant MiFID exemptions are 2(1)(i) and (k), which are specifically tailored on commodity firms, and 2(1)(b) and (d), which exempt firms dealing exclusively for their parent company and firms dealing on own account. She said other important issues are the definition of financial instruments and the calibration of MiFID and CRD to commodity businesses. Mrs Velentza called for clarity in the exemptions and a level playing field. Moreover, she claimed that regulation should not create barriers of entry, which discourage participation, liquidity and the efficient functioning of commodity derivatives markets. There should be an appropriate level of regulation for commodity markets in regard to prudential policy, conduct of business and transparency requirements, Mrs Velentza argued. The issues of capital requirements, large exposure, maturity ladder, client categorisation, information available to regulators – transaction v. position reporting, super-equivalent national regimes and exemptions should all be dealt with adequate, proportional legislation. Moreover, Mrs Velentza was concerned by market failures and widespread information asymmetries, in particular transparency of fundamental data in physical commodity markets. She said the present definition of commodity derivatives is satisfactory and no special regime for specialist firms is required. She also favoured maintaining the current exemptions. Mrs Velentza envisioned three options for commodity firms: (1) *removal of art 2(1) (k) of MiFID and art 48 of the Capital Adequacy Directive and application of proportionate MiFID and CRD requirements.* The pro of option 1 rests in its clarity; while the con lies in the difficulty of determining what is appropriate. (2) *Creation of a specialist regime*. The pros of option 2 are increased liquidity and support for the market. The con is less prudential oversight. (3) *Retention of current exemptions with limited prudential rules*. The pro of option 3 rests in maintaining the status quo; the con is legal uncertainty.

After the coffee break, the first panel discussed the issue of prudential requirements for commodity firms. **Anthony Belchambers**, Chief Executive, Futures and Options Association,

moderated the debate. Mr Belchambers claimed that appropriate prudential regulation does not necessarily imply a light-touch regime. He asked the question of why commodity firms should be subject to a special regime and argued that they pose a low level of systemic risk if compared to financial institutions. Mr Belchambers also maintained that regulation must be proportionate and tailor-made in order to ensure a level playing field.

Tim Plews, Partner, Clifford Chance, discussed US and Swiss regulation of commodity derivatives. Mr Plews argued that in the US exchanges set capital requirements in function of the assets held by market players. The presence of clearinghouses reduces systemic risk and regulators supervise exchanges rather than single actors. On the other hand, off-exchange transactions are not subject of any prudential regulation, Mr Plews claimed. He declared that Swiss regulation distinguishes between standardised derivatives – which are regulated – from non-standardised derivatives – which are not. Mr Plews admitted that retail exposure to commodities has increased through managed funds.

Simon Smith, Compliance Officer Europe, Shell International Trading and Shipping Company, argued that commodity firms do not pose any considerable systemic risk. Mr Smith said that the role of Shell is not to speculate in the market but to hedge its price risk. Mr Smith admitted, though, that Shell takes position on future prices in the derivatives market. He praised MiFID for levelling the playing field in financial markets regulation. Mr Smith affirmed the Financial Service Authority (FSA) supervises Shell's parent company under UK's national regime for energy firms, and Shell's European branches are exempt from MiFID under article 2(1)(k). Mr Smith said that Shell undertook a cost assessment for the implementation of the CRD and found that its full application would cost Shell hundreds of millions of dollars. Moreover, he added that forward prices are very difficult to plug into the calculation for capital requirements. Mr Smith claimed that 140 of Shell's customers did not fall under the professional category as it is presently defined in MiFID. Mr Smith said that Shell's standing is more secure than certain banks, and that Shell is very unlikely to fail. Therefore the full application of CRD would not be proportionate.

Edward Corcos, Head of Compliance, Amalgamated Metal Trading, focused his intervention on the case of its parent company. Mr Corcos said that Amalgamated Metal Trading is a fairly small-sized firm with 45 people, and that its origins lie in the industrial background of its parent company – Amalgamated Metal Corporation. Mr Corcos affirmed that the trading company mainly deals with commercial customers who use its business for hedging purposes, admitting, though, that some commodity funds also use Amalgamated's services. Mr Corcos argued that the London Metal Exchange is a forward, physical market. He said his company endorses the CESR-CEBS advice to the Commission. The cases of bankruptcy of Enron and Refco show that specialist commodity firms pose no major systemic risk, Mr Corcos claimed. Moreover, Amalgamated is already subject to FSA's chapter 3 capital requirements. Mr Corcos argued that nothing had changed since the MiFID exemptions for commodity firms were implemented. Mr Corcos added that CRD rules are not suitable to specialist commodity firms because they originated from banking regulation. Bank loans have long maturity, whereas most of Amalgamated's loans have 3 months of maturity, Mr Corcos said. He also claimed that the full application of CRD would imply that Amalgamated put 88% more capital than it does now. Mr Corcos concluded saying that commodity markets are not comparable to financial markets and some business would just move to Dubai if excessive regulation is implemented.

Florence Sirel, European Law, Group Legal Department, BNP Paribas, spoke about the opposition of the European Banking Federation to retain the exemptions to MiFID and CRD for commodity firms. Mrs Sirel argued in favour of a level playing field, with no different treatment for commodity firms with respect to other financial firms. Mrs Sirel said that when commodity firms act as intermediaries they should be subject to prudential regulation because they are linked

indirectly to the financial system. Moreover, she claimed that the exemptions create legal uncertainty hampering further development of commodity markets. Mrs Sirel also highlighted how commodity firms are not diversified and are therefore exposed to considerable risk. She said the European Banking Federation favours the full application of the CRD to specialist commodity derivatives firms because of competitive advantage concerns. Mrs Sirel concluded arguing that the maturity ladder approach does not fit the business model of commodity firms and should therefore be disregarded.

Following the lunch break, the second panel discussed the details of the MiFID exemptions and how these work in practice. **Guido Ferrarini**, Professor of Business Law and Capital Market Law, University of Genoa, moderated the debate. Mr Ferrarini stated that the also the legal issues arising from the MiFID exemptions should be looked at. He said MiFID conduct of business rules aim to address information asymmetries between counterparties, and the scope of the directive, which is targeted at investment firms, is clear. However, Mr Ferrarini raised concerns on the definition of investment firms and the scope of the exemption (i), which was interpreted divergently by member states. Mr Ferrarini asked whether a better wording for the exemption could be found.

François-Xavier Olivieri, Head of Legal Department, Gaselys, argued that the principles of investor protection and legal certainty should be at the core of regulation. He added that customer protection should replace investor protection as a goal. Mr Olivieri said that the current exemptions do not achieve this objective because – depending on the nature of the firm they face – customers face differing legal frameworks. Legal uncertainty raises further concerns, since companies have difficulties in assessing their legal status, Mr Olivieri argued. He went so far as to say that the scope of the exemptions is terribly unclear. Mr Olivieri called for regulators to separate CRD from MiFID and find the rationale behind each text. He added that regulators should find when customers need protection. When customers do not depend on the expertise of the firm, the exemption from MiFID is warranted, otherwise they are not, Mr Olivieri concluded.

Gary Mander, Executive Director, Legal and Compliance, Morgan Stanley, said his company trades a wide variety of cash-settled and physically-settled contracts in gold, oil, freight, metal, gas and agricultural, and it also offers risk management services to other firms. Mr Mander stressed that the EU regulatory framework for carbon emission trading is ambiguous. He added that the issues with the market abuse regime need to be addressed and regulation should have clearly defined boundaries. Mr Mander approved the changes in the client categorisation regime proposed by CESR-CEBS because size cannot be the sole determinant of a professional entity. He concluded arguing that the current definition of commodity derivatives is unclear.

Marc Cornelius, Lead Advisory Policy and Regulation, IST Compliance, BP, emphasised the legal uncertainty surrounding the MiFID exemptions. This uncertainty has very practical consequences for a company such as BP, Mr Cornelius said. He illustrated how eliminating the exemption 2(1)(i) could bring BP under the scope of MiFID, despite the fact that BP is not an investment firm. As evidenced by Shell's cost assessment, the full application of the CRD could cost hundreds of millions of dollars to BP, Mr Cornelius warned.

Wayne Smith, Deputy Head of Department, Regulatory Policy and International Affairs Division, Authorité des marchés financiers, said it is essential to make the MiFID exemptions right. He argued that it is critical to ensure legal certainty both in the scope and the definition of the exemptions. Mr Smith suggested the two exemption be maintained but with a slightly better wording. Having clear objectives in mind and defining with precision the terms used would be of great help, Mr Smith claimed. He added that the use of level 3 guidance represented a tool to achieve clarity. Mr Smith concluded advocating for a client categorisation regime that was

principle-based in order to adjust for the difficulty in including small firms in the professional category.

The third and last panel discussed the issues surrounding the Commission's 3rd Energy Package. **Peter Styles**, Chairman of the Electricity Committee, European Federation of Energy Traders, opened the panel by encouraging the speakers to discuss the benefits of record-keeping and transaction reporting, and the trade-off between market efficiency and market abuse. Mr Styles summarised the findings of the DG Competition's Sector Inquiry arguing that the electricity and gas markets experience market failure and difficulty in transacting.

Juan Alba, Director Regulatory Affairs, Endesa, said he does not question the findings and the conclusions of the Sector Enquiry. However, concerns raised in the Inquiry have to do more with unbundle of distribution from generation, reduction of barriers of entry and market fragmentation rather than lack of transparency, Mr Alba argued. He added that competition and market structure are the issues to look at when trying to account for high energy prices. It is true, Mr Alba claimed, that information asymmetries are pervasive in the electricity and gas markets, but competition regulation is the right tool to address this problem. Mr Alba said that although record-keeping and market monitoring are necessary, the detection of suspicious behaviour should be left to brokers and information providers. Mr Alba maintained that after carefully being assessed, legal transparency obligations should be put in place. He argued that information about the transmission network should be publicly available. However, Mr Alba added that excessive disclosure could deter the entrance of new players in the market. He asked to what extent a company which invested in a power plant can take advantage of inside information. Mr Alba concluded saying that he is not totally convinced that a tailor-made market abuse regime is necessary. In the end, he said, the gas and electricity markets are not fully liberalised because national governments do not trust market mechanisms to ensure fair energy prices.

Adam Cooper, Director, Regulatory Affairs, Merril Lynch Commodities claimed the state of the electricity and gas markets depend on the will of governments. Because of a generalised lack of confidence in the functioning of these markets, liberalisation is not politically viable, Mr Cooper said. He said he favours a tailor-made regime for gas and electricity because market integrity attracts liquidity. Mr Cooper added that market monitoring hinges on disclosure and the 3rd Energy Package does not address transparency concerns. Mr Cooper called for a standardised format for information disclosure. Clearly the problems rest with how you implement the disclosure. Mr Cooper claimed that it is useless to address market failure until market confidence is restored. To achieve that objective transparency is critical, Mr Cooper concluded.

Vera Blei, Editorial Director, European Power, Platts said her company wants deep and liquid markets. She argued that transaction reporting has its pros and cons. On the downside, transaction reporting may deter small players, Mrs Blei claimed. She maintained that on-exchange and brokered transactions already enjoy high level of transparency. Mrs Blei questioned the ability of regulators to handle huge amounts of disclosed data, and proposed that quality rather than quantity matters. Mrs Blei affirmed that the US Federal Energy Regulator Commission (FERC) could provide a useful model. In 2003 FERC advanced a list of voluntary principles for information providers to abide for, and in 2007 it decided against enforced data collection, Mrs Blei said. She concluded arguing in favour of disclosure of aggregated volumes.

Maria Velentza closed the public hearing with a few remarks. She called for proportionate and adequate regulation with regard to MiFID, CRD, MAD and the 3rd Energy Package. Mrs Velentza claimed that transaction reporting, record-keeping and MiFID requirements should adapt to the client. She added that the Commission will attempt to strike a balance between market efficiency, consumer protection, and transparency. Moreover, the Commission will monitor the regulatory

developments in the US, Mrs Velentza said. She argued that paramount concerns are the avoidance of barriers of entry, EU competitiveness and a level playing field. The review of the MiFID exemptions and the definition of financial instruments will be published before December 15, 2008. Mrs Velentza maintained that the MAD regime needs update. She concluded noting that the Commission is a political organism and as such it will balance the political arguments with the financial and economic context.

Piero Cinquegrana