Commodities

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LEGAL METAL

Special edition - regulatory focus

As the EU's financial reform programme moves into an even more intensive season, and the UK's restructuring of UK regulation heads towards an early-2013 effective date, we are focusing this issue of HFW's Legal Metal on regulatory issues. At the end of September the European Securities and Markets Authority (ESMA) and European Banking Authority (EBA) published draft technical standards for the implementation of the European Market Infrastructure Regulation. In our leading article Robert Finney, a Regulatory specialist, reviews that Regulation, its requirements for participants and users of derivatives markets and particularly its impact on London Metal Exchange (LME) business. Three EU measures in advanced stages of the legislative process are likely to have a major impact on metals and other commodities markets:

- MiFID II, the package of a new directive and regulation to update the 2004 Markets in Financial Instruments Directive (MiFID).
- The Market Abuse Regulation, which updates the 2003 Market Abuse Directive (and is part of a package including a new directive imposing criminal sanctions for market abuse).
- CRD IV, a directive and regulation which will implement Basel III capital and liquidity standards in the EU.

In addition, the Alternative Investment Fund Managers Directive (AIFMD), which will become effective in mid-2013, is set to impact funds that invest in commodity markets and providers of services to them. We shall cover these measures in future editions of Legal Metal, but our second article in this edition turns the spotlight on the approval process for the LME's acquisition by the Hong Kong Exchanges and Clearing: having been announced in June and approved by members in July, why has the deal not yet gone through?

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EU's OTC Derivatives Regulation impacts LME business

In July 2012, the Council of the European Union finally adopted the Regulation on OTC derivatives, central counterparties and trade repositories, commonly known as the European Market Infrastructure Regulation (EMIR). Members and users of the LME will be affected. Robert Finney and David Chalcraft take a look at the main provisions of EMIR and consider some of its potential impacts.

EMIR has arisen from concerns about risk and lack of transparency in Over-the-Counter (OTC) derivative markets. In the financial crisis it was perceived that OTC derivatives contracts played a significant role in the near collapse of Bear Stearns and AIG and the failure of Lehman Brothers, yet little information on the market was available publicly or to regulators. In the absence of central counterparties (CCPs), market counterparties were to a degree interdependent, giving rise to a risk of global financial instability. CCPs are interposed between parties to contracts traded on one or more markets, becoming *"the buyer to every seller and the seller to every buyer"*. By replacing parties' credit exposure on each transaction CCPs insulate market participants from each other - even if the consequence is that CCPs' own systemic importance increases and some become "too-big-to-fail" institutions.

The world's leading economies recognised the need to reduce financial instability, and a consensus in favour of a series of risk mitigation measures was reached at the 2009 G20 summit in Pittsburgh:

- All standard derivatives contracts should be cleared through CCPs by end-2012 at the latest.
- They should be traded on exchanges or electronic trading platforms, where appropriate.
- OTC derivative contracts should be reported to trade repositories.
- Non-centrally cleared contracts should be subject to higher capital requirements.

EMIR seeks to establish the framework to achieve this in the European Economic Area (EEA), and to meet other objectives such as reducing risk and setting standards for trade repositories (TRs) and CCPs.

EMIR entered into force in mid-August 2012 but its reporting and clearing obligations seem unlikely to become effective until mid-2013. Meanwhile, implementing measures are being developed by the European Supervisory Authorities and will be submitted to the European Commission (the Commission) for adoption.

EMIR's substantive requirements

Clearing and reporting

1. Clearing of certain standardised OTC derivatives contracts through CCPs where the parties are financial entities or are non-financial firms whose OTC derivatives positions exceed a set clearing threshold (NFCs+). The clearing threshold is described in more detail below.
2. Reporting of all derivatives contracts to trade repositories without duplication and (1) whether or not cleared through a CCP, and (2) whether traded OTC or on an exchange (or other organised platform).

A trade repository is a fairly new type of commercial organisation responsible for collating and managing records of OTC derivatives contracts. EMIR imposes detailed reporting requirements upon trade repositories. The European Securities and Markets Authority (ESMA) will be responsible for overseeing them.

Which contracts must be cleared?

OTC derivatives, for the purposes of EMIR, are those not traded on markets which are regulated markets or equivalent non-EEA markets under the EU's Markets in Financial Instruments Directive (MiFID). Not all OTC derivatives will be subject to mandatory clearing through a CCP:

- EMIR applies only to derivatives within the scope of MiFID or, in due course, the new legislation which is due to reform and replace MiFID (MiFID II). Most notably, physically-settled currency forwards are generally excluded.
- Other than the reporting obligation, EMIR is generally disapplied in relation to certain types of counterparty (mostly central banks and bodies responsible for public debt management).
- As indicated above, a contract with a non-financial counterparty (NFC) below the clearing threshold need not be cleared.

- Certain intra-group transactions will be exempt from clearing.

- EMIR contains complex provisions regulating the circumstances in which contracts with entities established outside the EU must be cleared.

- Only classes of derivatives specified in regulations adopted by the Commission (on ESMA's advice, after public consultation) will be subject to mandatory clearing. Once CCPs are formally authorised for the purposes of EMIR (in mid-2013), ESMA will consider which of the OTC derivatives cleared by them should be designated for clearing. A clearing recommendation will be based on the degree of standardisation of contract terms and operational processes for the relevant class of OTC derivatives, the degree of liquidity, and the availability and quality of pricing information.

Indirect clearing and reporting

Counterparties can delegate reporting - for example, an NFC could agree that its financial counterparty ("FC") on a trade reports that trade or, if the trade is cleared, that the relevant CCP or CCP clearing member reports it. However, the arrangements must avoid duplicative reporting.

In addition to clearing as a clearing member or a clearing member's client, EMIR made provision for a new concept, namely indirect clearing arrangements with a clearing member. These are interpreted by ESMA as covering situations where a clearing member's client is in turn providing clearing services to "indirect clients". Such arrangements must achieve equivalent protection of the counterparty's positions and assets, and not increase counterparty risk. ESMA has recommended a range of specific obligations be imposed on CCPs, clearing members and direct clients to achieve this – one of the more controversial areas of ESMA's proposals.

Mitigation of risk

Strict risk management requirements, including initial and variation margin, will apply to derivatives which are not cleared. Contracts may be uncleared because the contract is ineligible for mandatory clearing or because a party is not subject to the clearing obligation. Both FCs (such as banks, investment firms, investment funds and insurers) and NFCs must implement robust procedures to measure, monitor and mitigate credit and operational risk in accordance with detailed technical standards. The Commission will adopt these on the basis of drafts submitted by ESMA or jointly by the European Supervisory Authorities (ESAs), ESMA and the banking and insurance/ pensions authorities.

Last month ESMA published draft regulations in respect of:

- Prompt confirmation of transactions.

- Regular revaluation (generally, daily and through marking-to-market).

- Regular reconciliation of portfolios and portfolio compression reviews.

- Agreed dispute resolution procedures.

Consultation on the ESA drafts will include:

- Risk management arrangements for FCs and NFCs+, in particular:
  - Regular exchange of variation margin or collateral and (probably) posting of initial margin.
  - Levels and types of collateral.
  - Segregation arrangements for margin and collateral.

- The extent to which any (or any additional) capital requirements should be imposed on FCs to cover uncollateralised risks.

- The criteria and procedures for the various intra-group exemptions from collateralisation requirements.

Intra-group transactions, though generally not subject to mandatory clearing, will be subject to collateralisation unless there is *"no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties"*. While EMIR contains detailed and complex requirements and exemptions on this, certain aspects are still to be fleshed out in technical standards.

The ESAs issued a discussion paper on the details last March. However, consultation on these joint draft regulatory technical standards has been delayed to enable EU rules to be consistent with global standards being developed by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO).

Those standards are expected to be delivered by the end of 2012, so the EU public consultation is likely to be conducted in the first half of 2013.

Third countries

EMIR will have wide extra-territorial effect.

The clearing obligation will apply to contracts with third country counterparties (TCCs) in each of the following situations:

1. Where EU-established FCs or NFCs+ transact with TCCs who would be caught by the clearing requirement if they were established in the EU.

2. Where two TCCs transact and (1) both would be subject to the clearing requirement if they were EU established and (2) either the contract has a direct, substantial and foreseeable effect within the EU or imposition of the clearing obligation is necessary or appropriate to prevent the evasion of EMIR. ESMA will propose regulations on this subject but consultation on them has been delayed.

EMIR also limits the scope of the intra-group exemption in relation to third country (i.e. non-EU) affiliates. However, the Commission is empowered to recognise third country CCPs and TRs subject to rather strict conditions. EMIR's reporting and clearing obligations may be met through those institutions only once they are EU-recognised.

CCP Regulation

While TRs will be registered with and supervised directly by ESMA, EU CCPs will be authorised and supervised by member state competent authorities. In the UK this will be the FSA initially, but once the reform of the UK financial regulatory structure takes effect (in 2013), responsibility will transfer to the Bank of England (as distinct from the Prudential Regulation Authority). However, through “colleges” of supervisors, ESMA and other member states' authorities will have an influence.

EMIR sets out detailed requirements for the authorisation and supervision processes as well as substantive matters such as governance, conflicts of interest, outsourcing, conduct of business and, perhaps most importantly, prudential requirements.

Key objectives of the Regulation are to ensure that CCPs are adequately funded, that any default of a clearing member can be contained, and also to enhance the position of clearing member clients in a default. To this end, the prudential rules in EMIR includes requirements in respect of:

- Financial resources and management including liquidity, investment, and default.

- Margining and collateral, including segregation and portability of positions and associated margin (initial margin at least) and collateral.

How does EMIR affect existing transactions?

Once the reporting obligation comes into effect, all OTC derivatives entered into after 16 August 2012 will need to be reported, as will prior trades that remain open on that date.

Contracts must be cleared from the date the Commission specifies as the effective date for the relevant OTC derivatives class, when it adopts the relevant regulations. Longer dated contracts open when a CCP is authorised under EMIR will be subject to clearing, depending on the terms of any subsequent Commission regulation specifying that class of derivatives for clearing.

When does all this start?

EMIR is a directly effective regulation. No further national legislation is required to implement it. Whilst Europe will miss the G20's end-2012 deadline for OTC derivatives reforms to take effect, phased implementation of the new regime will begin very shortly afterwards. The provisions on operational risk management of non-cleared OTC derivatives are likely to apply from early-2013. By mid-2013, TRs should be recognised and CCPs authorised, so reporting and clearing obligations should be in effect very soon after that. Consultation on collateral requirements for non-cleared trades is likely to be in the first half of 2013, with regulations in effect by year-end.

In the EEA, the obligation to trade OTC derivatives on organised platforms “where appropriate” is being addressed in the MiFID II reforms, which means it is unlikely to be in effect for two or three years.

Impact on LME members and users

LME members and users will be affected by EMIR. Its impact on any

particular firm will depend on various factors including its regulatory status, the volume, venues and nature of its derivatives business, and the extent to which the categories of derivatives it trades are subject to clearing.

Although LME members in categories 1, 2 and 4 are generally FSA authorised firms, they may not necessarily be FCs under EMIR. For example, firms exempt from MiFID may be NFCs under EMIR. However their status may change when MiFID II reforms are implemented since these are likely to amend or delete certain exemptions favoured by commodities firms.

Many LME members and most users will be NFCs, which means that they may not need to clear OTC derivatives provided that they do not exceed the clearing threshold set for any class. ESMA proposes that a threshold be set by reference to a notional amount in each of five classes, namely credit and equity derivatives (each with a threshold of €1 billion notional) and interest rates, foreign exchange, and commodities/other derivatives (each with a threshold of €3 billion). In calculating whether it has exceeded any threshold, an NFC must include OTC derivatives of non-financial affiliates but can omit hedges - being OTC derivatives used to reduce risks directly related to the NFC's or its group's activities. Care must be taken in excluding any derivatives positions from the calculation on the basis that they are outside the scope of MiFID. Under ESMA's current proposals for thresholds, if a NFC exceeds the clearing threshold in any one class it becomes an NFC+ and must clear its OTC derivatives not just in the single asset class in which it has exceeded the threshold, but in all OTC derivative contracts (except those with other NFCs who are below the threshold).

No decision has yet been taken on whether and to what extent OTC derivatives in base or other metals (including LME lookalikes or *"white"* contracts) will be subject to the clearing obligation. Mining companies, end-users of metals and trading companies which use OTC derivative contracts to protect against commercial risks may well avoid the clearing obligation but, unless they can escape EMIR's broad extra- territorial reach, they cannot avoid the obligation to report OTC derivatives (though this can be delegated), nor the collateralisation and other risk management requirements on uncleared trades. Since the basic principles were agreed by G20 leaders and developed in global regulatory fora, many countries around the world are implementing requirements that are broadly equivalent to EMIR.

"LME members and users will be affected by this new regulation."

Segregation is an important aspect of EMIR, to ensure that CCPs keep records and accounts to enable assets and positions to be distinguished and protected in the event of a counterparty's or CCP's insolvency. EMIR prohibits non-segregated client contracts and margin/collateral, at least in respect of OTC derivatives. CCPs will offer segregation of clearing member and client positions and assets - omnibus client segregation and/or individual client segregation (where the assets and positions of each client of a clearing member must be distinguished from those held for the account of other clients).

The collateralisation and segregation requirements could have a major impact on LME business. Traditionally many brokers have extended credit lines to fund client margin, with that margin held at the clearing house in the clearing broker's non-segregated account. We expect that these facilities will be reduced or restructured, or even disappear. More collateral is likely to be required from each client and counterparty.

In any event, clients' costs of LME business will increase. In addition to the impact of Basel III implementation, regulated firms' capital charges for both uncleared business and exposures to CCPs will increase under the reforms proposed in the new Capital Requirements Directive (CRD IV). It remains uncertain to what extent those commodity firms currently benefiting from exemption from MiFID or (for firms which are not MiFID exempt) exemption from the capital requirements of the original Capital Requirements Directive (CRD) will be able to avoid these regimes in future. The Commission has yet to announce any proposals for a specialist capital

regime for commodities firms to replace the CRD exemption when it expires at the end of 2014.

There is also a concern that indirect clients may be adversely affected, for example, where a category 1 or category 2 LME clearing member clears for a client which is itself an intermediary, the clients of that intermediary will be entitled to segregation although currently they are often unknown to the LME member.

Finally, title transfer collateral arrangements with retail clients (as distinct from security collateral arrangements) may be living on borrowed time. ESMA's draft regulations would allow title transfer arrangements but such arrangements with retail clients seem likely to be prohibited under MiFID II.

Conclusion

Members and users of the LME will be affected by this new regulation; how far remains to be seen. With the optimistic implementation date of the end of 2012 fast approaching, there is much for members to consider. Full compliance with obligations imposed will not kick in until late 2013/early 2014, except for certain (mostly operational) risk management measures which may apply from January 2013, even though the Commission has not adopted the relevant implementing Regulation.

For more information, please contact Robert Finney (pictured on page five), Partner, on +44 (0)20 7264 8424 or robert.finney@hfw.com, or your usual contact at HFW.

The LME sale - what's the hold-up?

After a strategic review and bid processes lasting almost a year, on 15 June 2012 the board of the LME's parent company announced that it had entered into a framework agreement with Hong Kong Exchanges and Clearing (HKEx, holding company of the Hong Kong Stock Exchange) on the terms of a recommended cash offer for LME Holdings, to be executed through a shareholder-approved and court sanctioned scheme of arrangement. Several weeks later full details and documents were circulated to ordinary shareholders, who approved the proposed transaction at meetings on 25 July. Since then there has been almost no news of the deal. So what's happening?

The circular to shareholders in respect of the scheme envisaged that the effective date of the transaction would be in the final quarter of 2012. As the sale is being effected through a scheme of arrangement under the Companies Act 2006, court approval is required and the LME will not apply for that approval until certain conditions are satisfied. In fact, there are fewer conditions than in many takeovers, and the main outstanding condition is that the FSA must approve the acquisition by HKEx. If the court approval has not been received and filed with the Registrar of Companies by a longstop date of 15 March 2013, then the scheme lapses (unless HKEx and LME agree an extension, though that itself could require court approval).

What is a scheme of arrangement?

A scheme of arrangement is a procedure under the Companies Act 2006 whereby a company can make a compromise or arrangement with members or creditors. It is frequently used in mergers and acquisitions, whether under the Takeover Code or not,[1] where it commonly involves also a reduction of share capital. Schemes must be approved by the court as fair and reasonable and a genuine agreement between a company and its members (or creditors). Although approval of a court-convened meeting of members (or creditors) is generally a critical element of any scheme, the vote is not binding on the court. Where a capital reduction is proposed, that must be approved by a shareholders' general meeting – hence the two meetings of LME ordinary shareholders (court meeting and EGM) held in quick succession last 25 July. Note that the B shares are not part of the scheme and will continue to be held by members of the LME following completion of the Scheme.

Advantages of a scheme

Although a scheme of arrangement is generally higher than a simple recommended offer to purchase shares in a target, this is outweighed by the advantages, which are even greater where, as with the LME, there is a reduction of capital. The main advantages are:

- All members are bound by the scheme once the court has sanctioned it. This means that the acquirer does not need to achieve 90% acceptances in order to compulsorily apply the remainder, and is not left with minority shareholders.

- Further more, achieving 100% control is therefore quicker than with an offer.

1. LME Articles include only some limited protections of the kind provided by the Takeover Code. The HKEx acquisition is not governed by the Code nor subject to the jurisdiction of the Takeover Panel.

- No stamp duty is payable on transfer of shares, since no transfer of shares takes place: HKEx will become owner of the LME because the reserve resulting from cancellation of existing ordinary shares (through the reduction of capital) will be applied to pay up new ordinary shares issued to HKEx's bid vehicle in exchange for the consideration payable to the current ordinary shareholders.

FSA approval

Ownership and control of a UK exchange like the LME, as a "recognised investment exchange" (RIE) under the Financial Services and Markets Act 2000, has always been an essential part of the recognition requirement that the exchange be a fit and proper person. The FSA has therefore always had an interest in vetting significant changes. However, with the 2007 implementation of the EU Markets in Financial Instruments Directive (MiFID), this role of the FSA was formalised, and the new regime requiring the FSA to be notified of any proposed change of control and empowering the FSA to approve or object to such proposal was tightened in 2009.

This is the current stage of the LME acquisition. Although there would have been extensive discussions with the FSA during the bid process, the FSA must consider the proposal in detail following formal notice being filed by HKEx some weeks after the 25 July vote.

In order to approve the acquisition, the FSA must decide that the acquisition poses no "threat to the sound and prudent management of any financial market operated by the [RIE]". In assessing this the FSA must consider:

- The suitability of the acquirer.
- The financial soundness of the acquisition.
- The likely influence of the acquirer on the exchange.

Although technically this does not equate to a full review of how the exchange will comply with the recognition requirements post-acquisition, it is likely to cover many of the same issues, and the FSA will be updating the risk assessment it maintains in respect of the LME.

As indicated above, an exchange's connections with group companies and other connected entities or individuals are key considerations in assessing the exchange's own fitness and properness. Governance and conflict management arrangements are key factors in this, so it is no surprise that the acquisition proposal envisages that the board of LME Limited itself will comprise a majority of independent non-executive directors and even LME Holdings will have only a minority of HKEx nominated directors.

As a matter of course, the FSA will review HKEx's finances and the bank borrowing arrangements which are financing most of the consideration, but also the ongoing strategy and financing of the group as it relates to the LME. In particular, the FSA will examine HKEx's intentions regarding the business of the LME, especially in the three areas described in the circular as "key". These are:

- Preserving and enhancing the LME's existing business model.
- Expanding the presence of the LME in Asia and China.
- Developing the LME, in terms of IT (especially to develop LME Select and drive growth in electronic trading), new products and self-clearing through LME Clear.[2]

Technically the FSA has only three months to reach a decision. However, in practice the FSA takes time to consider whether or not the notice received is complete, and may seek further information or assurances before the formal assessment period starts. Although it is generally expected that FSA approval will be forthcoming by year-end (indeed HKEx must pay LME £25 million if it is not received by the longstop date), the FSA due diligence process must be equally thorough despite the commercial rationality of the deal and the acquirer's credentials as an exchange and clearing house operator in an established market and jurisdiction.

So, in short, there is no hold up. The FSA's approval for the acquisition of any financial institution takes time, and we can look forward to LME's sale to HKEx completing within the next two to three months.

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2. Note, however, that HKEx has committed to preserving the operation of the Ring (including open-outcry trading) until at least January 2015.

Robert Finney joins HFW

Many readers will be aware of Robert's arrival at the firm in May. Robert's practice focuses on derivatives, trading and financial regulation, particularly in relation to metals and other commodities markets. He has a range of regulated and unregulated clients, including banks, investment institutions and other financial businesses. He assists those involved in trading physical commodities and commodity derivatives, including producers, processors, trading houses, brokers and investment funds. He also has extensive experience advising exchanges and other market infrastructure providers.

Robert has over 20 years' experience of exchange-traded and OTC derivatives and underlying commodities, especially in energy and metals. Robert is a regular speaker at conferences, and has written many articles on the impact of financial regulation on commodities businesses.

Over many years Robert has been listed for commodities, futures/ derivatives and financial services in the leading law firm directories, Chambers UK, Legal 500 UK and Legal Experts. He was voted "Best Legal Advisor - Regulatory & Commercial" at The Compliance Register Platinum Awards 2010 and 2011. He is a founder member of the Futures and Options Association, and a member of its Metals Working Group.

Many HFW clients will be concerned about the impact of forthcoming EU reforms on OTC derivatives reporting, collateralisation and clearing, and the extension of the MiFID and market abuse regimes. Since Robert has joined HFW, he has already received significant instructions to advise on these matters.

Conferences & Events

Commodities Breakfast Briefing
HFW London
(23 October 2012)

Global Energy Conference
Geneva
(29-31 October 2012)
Brian Perrott and Jeremy Davies

C5's OTC Derivatives Conference
Rembrandt Hotel, London
(6-7 November 2012)
Robert Finney and
Costas Frangeskides

Basel III and Trade Finance Conference
HFW Geneva
(29 November 2012)

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