



EUROPEAN FEDERATION OF ENERGY TRADERS

**Working Paper on the Application of Draft Investment Services Directive
to
Companies dealing with Energy Commodities Derivatives**

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Application of Draft Investment Services Directive to Companies dealing with Energy Commodities Derivatives

The following paper deals with the impact of the Investment Services Directive (“**ISD**”) as currently drafted by the European Commission. It is divided in four sections: **(i)** the distinction of the different types of trading companies (“**TC**”) dealing with energy commodities derivatives in the European markets; **(ii)** the implications of the current wording of the proposed ISD published in November 2002 for the TCs; **(iii)** the pros and cons for such TC’s from the application or not of the ISD; and **(iv)** the possible courses of action available from a strictly legal point of view.

1. Division of TC’s

In order to simplify this analysis, we have divided the TC’s participating in the European energy commodities market in four groups depending on their corporate structure:

Group 1	The trading arms of energy companies with assets in Europe: TC’s forming part of a conglomerate of companies. This group could include EDF Trading Limited, Endesa Trading, S.A., RWE Trading GmbH, etc.
Group 2	TC’s where the parent company itself within a group of companies carries out energy commodities derivatives trading activities without the intervention of a trading subsidiary or affiliate. This group could include Electrabel, S.A., etc.
Group 3	Banks or trading arms within financial groups (both as parent company and affiliate). This group could include Barclays Bank plc, J Aron, Morgan Stanley, etc.
Group 4	Dedicated TC’s not belonging to an energy company or belonging to energy companies with reduced or no asset presence in Europe: Duke, El Paso, Hetco, Cargill, etc.

2. Implications

The ISD, as currently drafted, establishes a framework for the regulation in the European Union of “*investment firms*”¹ who carry on business with third parties “*on a professional basis*” in any of the instruments specified in the ISD. There are several applicable exemptions in the Directive draft but the most relevant are:

- 2.1(b) firms which provide investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings;
- 2.1(h) persons dealing on own account in financial instruments as an ancillary activity to their main business, where that main business is not the provision of investment services within the meaning of the ISD or banking services under Directive 2000/12/EC;
- 2.1(i) undertakings whose main business, when considered on a consolidated basis, consists of dealing on own account in commodity derivatives;

Each TC should first consider whether the ISD potentially applies and if it does where it can benefit from any of the above exemptions.

For each one of the above groups the implications of the current wording of the ISD may vary. On the assumption that the wording of article 2.1(i) remains as it currently is (particularly the mention that

¹ “Investment firm” means any legal person whose regular occupation or business is the provision of investment services on a professional basis; (article 3(1) of proposed ISD)

business are to be considered on a consolidated basis), the impact of the ISD on the different groups of companies is as follows:

Group 1	These TC's may possibly benefit from the exemption under article 2.1(b) ² . Whilst it is uncertain whether these TC's could benefit from 2.1(i) (as currently drafted). If we want it to apply then it may need to be amended ³ .
Group 2	TC's may fall under the exemption contained in article 2.1(h). Unlikely to fall under article 2.1(i) as currently drafted.
Group 3	The ISD as currently drafted is likely to apply. Articles 2.1(h) and (i) most relevant possible exemptions.
Group 4	Subject to the individual structure of each TC's group, the ISD may possibly not apply as for these TC's the main business is dealing with commodities derivatives and falls under article 2.1(i). Again, depending on the business structure of specific TC's, article 2.1(h) may possibly apply.

3. Pros and Cons

A. The ISD would bring two obvious benefits for TC's:

a) *Passporting*: By applying the ISD to a TC the approval from a financial authority in any given Member State shall be valid in the other Member States. Currently TC's cannot benefit from passporting because this activity is not regulated in the financial services regulations in force in Europe. This means that TC's are subject to a variety of frequently ambiguous or poorly designed regulations, and to sometimes contradictory regulatory authorities.

b) *Market Confidence*: It is safe to assume that for a TC's counterparties it would be reassuring to know that such TC is somehow regulated and supervised by a competent financial services authority specially dedicated to such activity. This could potentially simplify and reinforce the credit approval procedures to which it is subject when dealing with other counterparties. It would additionally reassure counterparties that there are appropriate controls to prevent financial crime that are applicable on a crossborder basis.

B. The main disadvantage attached to the inclusion of commodities derivatives in the ISD is that there would be a requirement for TC's to increase their share capital to comply with capital adequacy requirements.

C. We are of the opinion that, under the current wording of the ISD, it is likely to apply to some of the groups of TC's identified in the first section of this paper.

Those TC's that do not fall under the ISD or that fall under one or more of the exemptions of article 2.1 experience one benefit and two disadvantages: (i) Benefit: None of such TC's would be subject to any capital adequacy requirements; and (ii) Disadvantages: None of such TC's would benefit from passporting or would be able to take advantage of the implicit market confidence implications attached to a regulated status (although there may be regulations on a national basis).

It is important to point out that the fact that if any TC is exempted from the application of the ISD does not mean that this will be a permanent situation. The European Commission has been very clear that the current exemption in article 2.1 (i) will be reviewed in 2 years after the ISD comes into force (but in any event before December 2006). Aside from the drafting of

² Although it will very much depend on the relevant TC's day to day business with the market as these TC's may engage in trading activities (or even consulting activities) with other counterparties.

³ Such amendment would involve that the mention "when considered on a consolidated basis" is deleted and that instead of referring to "commodities derivatives" it refers to "commodities and commodities derivatives".

the ISD, the risk of inappropriate capital adequacy requirements arising from the Capital Adequacy Directive is still a strong possibility.

4. Possible Next Steps

Account should be taken that the wording of the latest draft circulated by the European Commission and to be submitted to the European Parliament shall be subjected to substantial changes and is by no means the final version of the ISD. The uncertainty this involves requires from us that we monitor on a permanent basis any developments during this legislative process.

With that in mind we have prepared this section under the assumption that the ideal result is that TC's are included in the scope of the ISD in order for them to benefit from passporting but without having the burden of unreasonable capital requirements not appropriate for TC's. At present such an outcome is unlikely. It will be necessary that more time and effort are spent lobbying the Commission for suitable changes to the Capital Adequacy Directive.

It is not currently known what the final regulatory regime will look like, but there are three possible outcomes:

- a) *Scenario 1:* Exemption of commodity TC's from the ISD by exemptions being available to such firms. This is the formula followed (or at least intended) by the European Commission in the latest draft of the ISD. The consequence is that those TC's enjoying any of the exemptions will not benefit from passporting until an appropriate set of regulations is approved pursuant to the mechanism set up in the ISD. The benefit this alternative will bring is that TC's would not be subject to compliance with capital adequacy requirements. As said before, this would be a temporary situation. It is also a situation that is dependent upon the Commission providing clarity around certain definitions (identified above) and including an express provision to the effect that the exemptions in the ISD are applicable throughout the European Union and cannot be excluded by individual Member States.
- b) *Scenario 2:* Seeking the application of the ISD to all TC's in Groups 1, 2, 3 and 4. This would allow these TC's to benefit from passporting but would require them to comply with capital adequacy requirements on a permanent basis. The costs to firms would be substantial.
- c) *Scenario 3:* Find a way to apply the ISD to these TC's but excluding capital adequacy requirements for dealers in commodities derivatives. This could be achieved by re-defining the exemption in article 2.1 (i) so that the ISD applies to TC's and by providing for an exemption to the application of articles 11 (Initial Capital Endowment) and 17 (Ongoing Capital Endowments) to TC's. The argument to support this position could be the provision of article 13 of the Capital Adequacy Directive ("CAD")⁴.

Additionally, this course of action could be reinforced by the adoption of the "with or through" exemption currently accepted by the Financial Services Authority of the United Kingdom and used by a number of TC's in the European energy markets regulated by the FSA.

It is likely that to achieve either scenario's two or three (and possibly one) a degree of lobbying by EFET and its members will be necessary. In addition to lobbying on ISD issues, a further lobbying initiative would be necessarily focussing on the amendment of CAD.

We must bear in mind that any initiative undertaken to lobby on amendments to CAD should be supported by a specific technical proposal on a suitable capital regime, which will need to be submitted to the European Commission for its consideration. It is worth noting that the financial

⁴ "The Commission shall as soon as possible submit to the Council proposals for capital adequacy requirements in respect of commodities trading, commodities derivatives and units of collective-investment undertakings." (93/6/EEC)

burden on firms of producing such a draft regime will be significant, but the future savings potential is huge.

5. Conclusions

Efet's board has discussed the above issues during its most recent meeting. The view was that whilst the ideal outcome is the one described in Scenario 3 (which is highly unlikely in the short term), Efet is comfortable with the situation described in Scenario 1. It was agreed that Scenario 2 is not an option.

It was decided that for the time being Efet will assume a watchful approach to the evolution of the matter in hand. This approach will be reviewed periodically in order to take the necessary action if and when necessary. It was also decided to continue the close cooperation with ISDA and the FOA as it has been done to date. In the meantime, Efet is very keen to hear any comments any of its members may have in relation to this matter