

ISD2 mandates weather derivative regulation review

May 2004

The new EU Directive on Financial Instruments Markets could bring weather derivatives business into the regulatory framework that applies to other derivatives. The European Commission's decision on this question will affect a broad range of market participants, including those who would like the benefit of an EU-wide "passport" for their weather derivatives trading business and those who would rather try to keep this asset class outside the scope of regulation altogether.

Timetable for implementation of ISD2

The EU Council of Ministers finally agreed the text of the new Directive - sometimes known as ISD2 since it replaces the existing Investment Services Directive - last month, after protracted political negotiations. Member states now have until 30 April 2006 to bring their national laws and regulations into line with the new rules.

However, member states will not be able to finalise their national implementation programmes until the European Commission adopts implementing measures spelling out how they should address a number of particular issues, including if weather derivatives should be treated as "financial instruments" subject to the Directive. The Commission is likely to ask the Committee of European Securities Regulators (CESR) for technical advice on this shortly, which will trigger a period of public consultation and debate on the scope of financial regulation in this area. If the Directive were extended to cover weather derivatives then member states would be required to apply their licensing and other financial regulatory rules to a range of trading and advisory activities involving those derivatives.

Benefits of extended regulation

A number of market participants see clear benefits from extending the scope of regulation in this way.

- Extending the Directive would give EU licensed banks and other financial firms an EU-wide "passport" to sweep aside the barriers to cross-border business in weather derivatives that have been created by member state licensing requirements. Some member states already have financial services licensing rules that apply to weather derivatives business; the existing Banking Consolidation and Investment Services Directives do not address these rules, which already represent an impediment to cross-border activity.

- In addition, where weather derivatives fall outside the scope of financial regulation, firms may not benefit from the protections of special laws which guarantee the enforceability of close-out netting agreements or which protect financial contracts from the risk of invalidity under gaming laws.
- Including weather derivatives within the scope of the new Directive may also help confirm that these instruments are properly not treated as insurance contracts, subject to insurance regulation.

Directive exemptions

The new Directive does provide some protections that could allay the concerns of other market participants - particularly those that currently can operate without needing a financial services licence - about any proposal to extend the scope of regulation to cover weather derivatives. In particular, the Directive includes exemptions that would apply to:

- firms whose weather derivatives business is only ancillary to their group's main business (although this is not available to banking and investment groups); and
- firms that only trade for their own account in weather derivatives, without acting as a market maker or offering a system which "internalises" third party transactions.

These exemptions would most likely be of use to those who are end users of weather derivatives products rather than those who provide a package of risk management services to others.

Risks to market participants

Nevertheless, the changing regulatory landscape presents risks for all market participants. Even if the Directive is extended to cover weather derivatives, some market participants that already operate through specialised trading vehicles in the EU with the benefit of a local financial services licence may yet find that those entities fall within one of the exemptions in the Directive. In that event, they would not get the benefit of the passport to address the new extended licensing requirements that would apply across the EU. Alternatively, even if they get the benefit of the passport, they may find that the conduct of business or regulatory capital requirements that apply to licensed firms impose unacceptable costs (and those capital requirements are due for major change to implement the planned revisions to the Basel Capital Accord).

In addition, those who hope to stay outside the scope of regulation by relying on the exemptions in the Directive may find that member states elect to apply stricter national requirements. Firms that currently operate without needing a licence may find that this is no longer possible, because of stricter rules either in their home member state or in the member states where their customers or counterparties are located.

There will be particular concerns for firms that use trading vehicles located outside the EU to transact business with EU customers or counterparties. Non-EU firms cannot benefit from the passport regime and are likely to encounter greater barriers to transacting business with EU based customers and counterparties as a result of the Directive.

Likely outcome still unclear

It is by no means clear what the result of CESR's consultation process will be. The European Commission might choose to extend the Directive only where weather derivatives are regularly margined, are traded on an exchange or other trading platform or are cleared and settled by a recognised clearing house. The decision is likely to be influenced by how CESR and the Commission choose to address other classes of derivatives such as over-the-counter physically

settled commodity transactions and derivatives on freight, emissions allowances and economic statistics, all of which will also be the subject of consultation. However, regardless of the outcome, it is unlikely that the regulatory issues will go away. The Directive is only the first stage of a general overhaul of national regulatory systems and so more regulation is likely yet to come.

An earlier version of this article will appear in the May 2004 issue of Environmental Finance. This note is not intended to be comprehensive or to provide legal advice.

This newsletter does not necessarily deal with every important topic nor cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

Published by Clifford Chance Limited Liability Partnership, 10 Upper Bank Street, London E14 5JJ, United Kingdom.
Tel: +44 (0) 207 006 1000. Fax: +44 (0) 207 006 5555.
CONTACT: Chris Bates, +44 (0)20 70061041, email: chris.bates@cliffordchance.com; or Claude Brown, +44 (0)20 7006 1447, email: claudes.brown@cliffordchance.com