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Futures and forward contracts: How the Markets in Financial Instruments Directive (MiFID) implementation affects agriculture

Background: MiFID is the Markets in Financial Instruments Directive, and has been in force since 2008 as a cornerstone of the EU's regulation of financial markets. It seeks to improve the competitiveness of EU financial markets by creating a single market for investment services and activities, and ensure a high degree of harmonised protection for investors in financial instruments, such as shares, bonds, derivatives and various 'structured products'.

Politicians and campaigners responded very robustly to the financial market and commodity price rise events of 2007-08 believing these market developments demonstrated weaknesses in some of the underlying principles of MiFID, and highlighted areas needing reinforcement or revision. They had become concerned about development of new trading platforms and activities which fall outside MiFID scope and thus outside any regulations. Closing these gaps was the aim of MiFID II, and it seeks to address a more complex market reality with increasing diversity in financial instruments and new methods of trading. Similar discussions have taken place in the United States and other major global financial centres and have led to a strong regulatory response. It is worth noting that campaigning and regulation aimed at reducing **speculator** participation in grain markets has already **driven most publicly listed banks out** of EU wheat and oilseed rape futures trading (Barclays, BNP Paribas, Credit Suisse, Credit Agricole, HSBC) leaving the space to private international commodity shippers, sovereign and private managed funds where there is less opportunity for public scrutiny.

Access to Futures Markets: Grain production and trade organisations are in discussion with the Financial Conduct Authority to discuss where farmers traders and processors will be caught up in FCA oversight and are likely to limited in their access to forward pricing, as a major unintended consequence of regulation to reduce risk from banks and speculators and drive private trade (contracts made outside a regulated exchange like LIFFE) out of the market or onto regulated exchanges. NFU has been active in contributing to this highly technical debate for over two years, originally to help ensure the UK futures market has sufficient liquidity to continue. Lately attention has switched to physical and derivatives markets and work to ensure forward pricing, a fundamental element of grain marketing, is not put out of the reach of farmers through the administrative and financial burden of regulation.

What has happened: The EU Commission has taken the framework and language used to regulate **financial markets** and are in the process of applying them to **commodity markets** (electricity, agricultural commodities, oil and gas....). This was agreed in early 2014 as the Markets in Financial Instruments Directive, stage 2 (**MiFID II**). This Directive now has to be implemented, firstly interpreted as rules by European Securities and Markets Authority (ESMA) and in turn individual Member State Competent Authorities, like the Financial Conduct Authority in London. There is a nightmare of jargon and complex financial concepts to adjust to, but at worst individual businesses in the grain industry could be regulated in a similar way to banks.

Why does this affect farming? The risk is, if poorly implemented by the EU regulatory Authority ESMA, it will be much more difficult to **trade forward** in the way producers, traders and processors have been used to without all parties working through a regulated exchange (LIFFE and MATIF for example). The burden of cost and complexity risks will also reduce liquidity on the already thinly-traded LIFFE making it a less effective market and possibly hastening its end. would limit producers and consumers ability to manage risk, and become very much more reliant on retailers - as in dairy, beef etc.

What action has been taken? NFU has made representations to the EU Commission and been responding in press, on Radio and to the EU regulators on their consultation paper and discussion paper on proposals that risk making futures and options markets much less viable and introduce significant barriers for farmers using them directly or through their merchant/cooperative that would make price risk management tools, like forward contracts, regulated futures and options as well as OTC contracts much less available for farmers.

What is the next step? We are at the 11th hour in this process, but there will be further stages of consultation, formal and informal, aimed at refining the definitions, scope and requirement for exemptions needed for those who wish to buy or sell grain where financial instruments are involved. Currently the EU Regulator ESMA is seeking views on how to decide if forward grain trades that involve futures quotes in finalising prices are exempt from regulatory controls or not: http://www.esma.europa.eu/system/files/2014-1189.pdf under current (MiFID I legislation). This for example seeks to define if a **physical forward** trade is a **financial instrument** (and would become highly regulated in 2017) and asks: Is it a contract that can be physically settled, Is it a spot contract? Is it for commercial purposes? Does it have the characteristics of other financial instruments? To try and define the nature of the trade. NFU and AIC met the UK regulatory authority (Financial Conduct Authority (FCA)) on 1st December. While FCA were reassuring on some of the issues and their interpretation of the issues there are still some areas of decision-making which need to be managed very carefully and where legal definitions need to be very clear to prevent grey areas. It is also clear that one area which is going to cause us some difficulty is around the way in which some growers access financial instruments such as Options and Futures, if they use their Co-op/ trader to provide the contract, and if this is an Over The Counter (OTC) Financial Instrument, then it appears this would not be possible under the new regime and the only way growers could access hedging tools is by opening an account with a broker and trading the exchange listed instrument.

We expect a further consultation around the turn of 2014/2015 specifically on regulatory definitions and measures for post 2017 (MiFID II).

In response to previous MiFID II consultations, NFU has been seeking:

- Exemptions from position limits for farmers and farmer owned businesses (*This was lost at the political stage and position limits and position management will apply across the board to all exchange traded financial instruments however exempt firms/persons while still being a part of the position reporting regime must be exempt from position management*)
- Any limits must be based on a genuine appreciation of the size of agricultural commodity markets (AMIS is good but nowhere near accurate enough (e.g. biggest wheat producers and processors China, India and Russia do not provide clear data) to take action in response to ‘shocks’)
- Regulators should not take action to reduce positions (currently ESMA indicate intervention limited to upward price movements, but are silent on rapid falls in price).
- Recognition of national standardised contracts used in ex-farm trading, and new standard contracts as the basis for exemption from additional regulatory control. (*As we move forwards to exempt contracts which are for “Commercial Purposes” use of standards such as AIC No 1, FOSFA, etc. might provide demonstration of this proof*)

• Any regulatory action should avoid damage to liquidity and ultimately the viability of agricultural commodity markets.
• EFSA should recognise that each trade in an agricultural commodity will require two contracts with the exchange, one for the buyer and one for the seller, and that if market interlocutors participate, this will necessarily increase the number of trades involved (it must be accepted as normal for the whole or multiples of the whole of a country's crop to be traded on its futures exchange).
• Regulatory arbitrage could arise from the exercise of position management powers by ESMA: The original concerns of G20 leaders around rapidly growing markets and speculators are now arguably replaced by reduced liquidity and less participation by banks and similar institutions that have requirements of public reporting to shareholders.
• Farmers should be able to access electronic platforms, important in order to bring efficiency to trading and keep costs as low as possible and the use of hedging instruments attractive for farmers and their customers, without taking on additional regulatory burden.
• Farmers must remain automatically exempt from requirement of becoming a MiFID II authorised firm with the associated consequences. (*It should be noted that while it may be the case as to who is exempt, where farmers trade in exchange listed instruments Futures and Options the exemption WILL have to be applied for even if there is automatic granting by the local regulatory authority*.)

In Brussels, ESMA is very familiar with industry representation from banks and financial institutions and lately energy and metals, they and FCA in London are less familiar with agriculture. More contact will be necessary to inform regulators of the detail to help avoid unintended consequences.

Now the consequences have become clearer, NFU Combinable Crops Board concerns are likely to be shared by more UK commercial market participants, where in the past there had been greater support for MiFID II. Is there now more support from agriculture and the food industry?

Glossary:

AIC: Organisation providing cereal contract and arbitration services in the UK, e.g. AIC No1
ESMA: European Securities and Markets Authority EU regulator
FCA: Financial Conduct Authority UK regulator
FOSFA: organisation providing oilseed contract and arbitration services, for example for Rapeseed used with ex-farm trades
Futures: Contract made now for forward delivery (or cash settlement at forward delivery) at a given date
Derivatives: A financial instrument whose value is based upon other financial instruments, such as a stock index, interest rates or commodity indexes.
G20: Group of 20 leading economic nations
LIFFE: London International Financial Futures and Options Exchange, now owned by ICE
Liquidity: A condition that describes the ability to execute orders of any size quickly and efficiently without a substantial affect on the price. Institutional investors are inclined to seek out liquid investments so that their trading activity will not influence the market price.
MATIF: Marché à Terme International de France EU milling wheat, malting barley, maize and rapeseed futures exchange
MiFID: Markets in Financial Instruments Directive
OTC: Over the Counter trading not made on a regulated exchange
Option: 'insurance' – the right to a futures contract, if you choose to exercise it (i.e. when market strongly against you. If in your favour, you are ahead anyway) Minimises losses. Based on futures contracts. Can be traded.
Structured Product: pre-packaged investment product