



08 March 2004

Mr Fabrice Demarigny  
Secretary General  
Committee of European Securities Regulators  
11-13 Avenue de Friedland  
75008 PARIS

Dear Mr. Demarigny,

**Response to CESR's Call for Evidence on the Provisional mandates under the Future Directive on Financial Instruments Markets**

**About the International Petroleum Exchange of London Ltd.**

The International Petroleum Exchange (the 'Exchange') is Europe's leading energy futures and options exchange. Established in 1980, the Exchange provides open outcry and electronic marketplaces where industry participants can manage their price risk exposure in the physical energy market and is regulated in the UK by the Financial Services Authority as a recognised investment exchange under the Financial Services and Markets Act 2000. The Exchange offers five main energy contracts: namely Brent Crude futures and options, Gas Oil futures and options, and Natural Gas futures. On 10 August 2001, the Exchange became a wholly-owned subsidiary of IntercontinentalExchange Inc. The Exchange has over 140 Members which range from global investment banks, energy trading companies to proprietary floor traders, and daily volumes represent a notional value of over US \$4 billion. Our main contract, Brent Crude futures, is used in the complex of products for determining the price for two-thirds of the world's crude oil. The Exchange was commended as 'Energy Exchange of the Year 2003' by *Commodities Now Magazine*.

The Exchange has had the opportunity to review and contribute to the comments made by the Federation of European Securities Exchanges, the joint response of the International Swaps and Derivatives Association ('ISDA') and the Futures and Options Association ('FOA'), and the London Metal Exchange ('LME'). We fully support the comments made by these bodies, particularly those concerns expounded by ISDA and the FOA relating to the level of detail which is appropriate for Level II implementing measures. However, we also welcome the opportunity to make the comments outlined below.

## **General Comments**

### **1. Support the creation of an Experts Group on commodity derivatives**

The Exchange welcomes the opportunity to respond to CESR's Call for Evidence and feels that the Call for Evidence is an important but also preliminary element of industry consultation. The creation of the CESR Experts Group to advise on and contribute to the consultation process is also supported. However, in line with the views expressed by the FOA and the LME, we are concerned about the lack of expertise in commodity derivatives markets within the Experts Group. The extension of the Directive on Financial Instruments Markets to include commodity derivatives is perhaps one of the most significant changes to the scope of the Directive and therefore demands careful analysis. In justifying the extension of the scope of the Directive to include commodity derivatives, the Commission noted that "the absence of a single market framework for this business is anachronistic, particularly when one considers parallel steps taken to liberalise underlying commodity and energy markets."<sup>1</sup> Further, the Commission recognised the need to "take account of certain features specific to trading in these instruments, as well as the predominantly "wholesale/professional" nature of the market participants"<sup>2</sup> In ensuring that these objectives are met, it is imperative that full and proper analysis is carried out of the implications of the Level II implementing measures on firms active in the commodity derivatives markets, particularly the rules relating to the conduct of business particularly as this may be the first occasion on which such rules are extended to such firms. Such concerns are particularly pertinent to firms active in the nascent gas, power and emissions markets where arbitrary and oppressive regulatory requirements could preclude the development of vital pan-European markets in these products.

We would therefore ask CESR to reconsider its position and convene a meeting of commodity markets experts to discuss issues under the provisional mandate. The Exchange was involved in such a meeting in the context of the Directive on insider dealing and market manipulation which we understand CESR found extremely useful.

### **2. Urge CESR to carefully address the scope of application of the rules**

It is important to note that CESR's implementing advice will apply equally to small brokerage firms as well as investment banks. It is therefore imperative that the implementing advice is drafted at such a level that allows national regulators to craft differentiated standards for different types of institution. For example, the personal account dealing rules for a global investment bank will differ greatly from those appropriate for a small brokerage firm. Further, any prescriptive requirements which will apply to all investment firms should be underpinned by a strong and justified regulatory rationale.

In the UK, the FSA has recently developed detailed rules in this area which provide sufficient flexibility to meet the needs of different firms. We feel that it would be inappropriate for CESR to attempt to replicate this level of detail at Level II without providing sufficient scope for flexibility within national implementation.

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<sup>1</sup> The Proposal for a Directive modifying Directive 93/22/EEC on Investment Services, "Detailed Commentary on the content and provisions of the proposal", page 11.

<sup>2</sup> *ibid.*

### **3. Ensure that COB rules are proportionate and recognise the wholesale/retail split of clients**

Users of commodity markets are, in general terms, knowledgeable, experienced and professional. In terms of customer categorisation, they will be deemed 'eligible counterparties' or 'professional clients' under the ISD framework. Further, some users of the UK commodity derivatives markets rely on their classification as 'experts' under UK rules, in order to escape from being subject to prescriptive rules in this area and, due to the unscientific thresholds set within Annex II will not be able to be categorised as professional clients and will therefore be subject to the rules applied to retail clients. Such firms are clearly unable to 'opt out' of many of the onerous regulatory rules which the Directive quite rightly imposes on investment firms providing services for retail clients (unfortunately this is a matter for Level I rather than CESR). However, the split between the obligations owed to wholesale and retail clients should be paramount in CESR's mind when drafting its implementing measures in relation to the use of client funds, order-handling, the type of information given to clients (such as risk warnings) and the scope of the best execution requirements.

### **4. Encourage CESR not to duplicate existing work**

Many of the areas covered by the Call for Evidence are areas which have already been the subject of regulatory consultation by the International Organisation of Securities Commissions,<sup>3</sup> the Federation of European Securities Commissions ('FESCO') or CESR,<sup>4</sup> as well as national regulators. As so much work has already been done in this area, it is crucial that CESR's advice is guided by these existing standards.

### **5. CESR should acknowledge the role of the regulated market as a regulator in its own right**

It is also worth noting that there are a number of areas covered by the Mandates in which regulated markets will also have their own rules. These rules may overlap with the prevailing national legislation, but they reflect the particular needs of and are vital to the operation of that market. Such rules are based in contract between the market operator and the member, and are put in place in order to ensure that the particular regulated market fulfils the FESCO Standards for Regulated Markets – such as those requirements governing the access to the market thereby ensuring that membership is restricted to firms and persons who are fit and proper. By way of example, the Exchange requires that all applicants for membership of the Exchange must satisfy the Exchange that the applicant has sufficient systems and controls in place to ensure that all employees, agents and representatives are fit and proper, suitable, adequately trained and properly supervised to perform such functions. Any requirements put in place by CESR will therefore have a consequential impact on the rules put in place by regulated markets.

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<sup>3</sup> Such as the IOSCO Objectives and Principles of Securities Regulation (October 2003) and the Principles for the Oversight of Screen-based Trading Systems for Derivatives Products (October 2000).

<sup>4</sup> Such as the FESCO "Standards for Regulated Markets under the ISD" (December 1999) and CESR's proposed "European regime of investor protection – the Harmonisation of Conduct of Business Rules under Article 11 of the ISD" (April 2002).

## Specific comments

### Paragraph 3.1.1 – Compliance obligations and treatment of personal transactions (Article 13(2))

With respect to the treatment of personal transactions, CESR is urged to consider the proportionality of the proposed rules – clearly this is one area in which those rules applicable to a major international investment bank will not be equivalent for a small brokerage. Further, it is also worth noting that the regulated market on which trading takes place may have a particular interest in transactions executed by employees and officers of firms operating on its market. For example, the IPE Regulations provide that any officer, employee or agent or representative of a Member shall not trade either directly or through another broker for any account in which he is interested unless the following procedure is followed:

- (i) all transactions must be separately recorded and identified in the accounting records of the Member;
- (ii) the individual must have approval to trade for his own account from his Member firm and must be party to an appropriate written agreement with his Member firm;
- (iii) transactions must be cleared and margined as for any other client transaction;
- (iv) transactions must be monitored by senior management of the Member for whom the individual is an officer, employee, agent or representative;
- (v) such trades should be reported to the Exchange's Compliance Department within seven days of the date of approval.

Irrespective of the final outcome of CESR's work, clearly the exchange would wish to retain the right to impose such obligations in its rulebook.

### Paragraph 3.1.4 – Record keeping obligation (Article 13(6))

There are a host of record-keeping requirements within the existing European regulatory framework – including rules in the Directives on insider dealing and market manipulation (Directive 2003/6/EC) and money laundering (Directive 2001/97/EC). These obligations are augmented by FSA requirements relating to, for example, retention of client records and voice recordings. Further, regulated markets themselves have a number of rules – for example the Exchange requires, *inter alia*, that documents relating to complaints against the Member are retained for 3 months, trading records (including order slips) are retained for 3 years after the date of the transaction and recordings of telephone lines used for the receipt or giving of orders are retained for a minimum of three months.

In determining the required retention period, CESR should be alert to regulatory need and also the cost of retaining such records. It should be noted that although the electronic storage of data is cheaper, considerable costs will be incurred in dematerialising existing paper records and therefore the lower cost of electronic retention should not be used as an excuse for imposing undue record-keeping obligations.

### **Paragraph 3.4 – Best Execution obligation (Article 21)**

During 2003, the Exchange launched parallel trading of Brent Crude and Gas Oil futures by both electronic and open-outcry means simultaneously.<sup>5</sup> This raised a number of compliance issues and in giving guidance to its Members on the issue of best execution, the Exchange, like many other UK recognised investment exchanges, relies on the FSA's Conduct of Business rules which state that to provide best execution, a firm must:

- (1) “take reasonable care to ascertain the price which is the best available for the customer order in the relevant market at the time for transactions of the kind and size concerned; and
- (2) execute the customer order at a price which is no less advantageous to the customer, unless the firm has taken reasonable steps to ensure that it would be in the customer's best interests not to do so.”

The guidance to this rule also makes clear that if a firm can access prices displayed by different trading platforms and make a direct and immediate comparison it should execute the customer order at the best price available to the firm on such trading platforms, if this is in the best interests of the customer. The “best execution” requirement applies to Members in the circumstances of parallel trading of IPE contracts unless the customer has waived its right to the “best execution” requirement.

Any impact/change to the FSA's rules will force consequential amendments to the Exchange's rules.

### **Paragraph 3.5 – Client order handling rules (Article 22)**

Within the IPE Regulations there are a number of trading mechanisms which allow Members to deviate from the prompt execution of client orders and could therefore provide more favourable terms for clients. These include, block trades, exchange for physicals (EFPs) and exchange for swaps (EFSs) and discretionary orders. However, although the exact procedures for these trades vary, there is no delay in the reporting of an executed trade to a client and such rules are reinforced by a series of obligations covering abuse of client order and the priority and disclosure of orders.

### **Paragraph 3.6 – Reporting of transactions (Article 25(3), (4), (5) and (5a))**

The obligation to report transactions in commodity derivatives to the Competent Authority will be a new obligation for the Exchange and its Members. While we look forward to working with the FSA in order to find an appropriate technological solution to this issue, we would urge CESR to be cognisant of the cost of wide scale systems developments and undertake a separate cost-benefit analysis of such reporting requirements.

### **Paragraph 3.7 – Transparency obligations (Articles 28, 29, 30, 44 and 45)**

The pre- and post-trade transparency requirements for regulated markets (Articles 44 and 45) and MTFs (Articles 29 and 30) are restricted to shares admitted to trading. Article 65 provides a review clause concerning the possible extension of the scope of these provisions to transactions

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<sup>5</sup> Brent Crude futures contracts trade electronically between 02.00 and 22.00, and by open-outcry between 10.02 and 19.30 (Monday to Friday), and Gas Oil futures contracts trade electronically between 02.00 and 22.00 and by open-outcry between 09.15 and 17.27 (Monday to Friday).

in classes of financial instruments other than shares. It is therefore imperative that, at this stage, CESR limits its consideration to shares admitted to trading on those platforms and does not attempt to lay the framework for extension to other financial instruments.

**Paragraph 3.8 – Admission of financial instruments to trading (Article 40)**

In designing contracts, the UK derivatives markets rely heavily on the “Guidance on Proper Markets in Relation to on-Exchange Derivatives” issued by the Securities and Investment Board in 1993 and which to some degree has been incorporated into the FSA’s Sourcebook for Recognised Investment Exchanges and Recognised Clearing Houses. This covers, *inter alia*, guidance on the relationship with the underlying market, market values and liquidity. For your information, a copy of this Guidance is attached at Appendix 2.

We would also be grateful for further clarity as to what is meant by the phrase “parallel trading” contained on page 26 of the Technical Annex. As noted earlier, this is particularly pertinent to the Exchange which recently introduced the parallel trading of its Brent Crude futures and Gas Oil futures contract by electronic and open-outcry means simultaneously.

Please do not hesitate to contact me on +44 (0)20 7265 3608 or my colleague Mark Woodward on +44 (0)20 7265 5729 should you have any questions on the comments raised in this letter or wish to discuss any issues further.

Yours sincerely,

**Marc Leppard**  
**Director –Regulation and Compliance**

cc. Kevin Ludwick, Financial Services Authority  
Clive Maxwell, HM Treasury

## Appendix 1

### Members of the International Petroleum Exchange

#### GENERAL PARTICIPANTS

ABN AMRO Futures Ltd  
ADM Investor Services International Ltd  
AIC Ltd  
Amerex Futures Ltd  
Arcadia Petroleum Ltd  
Banc of America Futures Inc.  
Banc One Capital Markets  
Bank of Nova Scotia  
Barclays Capital  
Bear Stearns International Ltd  
BNP Paribas Commodity Futures Ltd  
BP Oil International Ltd  
Cargill Investor Services Ltd  
Carr Futures SNC  
Citigroup Global Markets Ltd.  
Credit Lyonnais Rouse Ltd  
Deutsche Bank AG  
Dresdner Bank AG  
Fimat International Banque SA (UK Branch)  
Fortis Clearing London Ltd  
Glencore Commodities Ltd  
GNI Ltd  
Goldman Sachs International  
J.P. Morgan Securities Ltd  
Lehman Brothers International (Europe)  
Man Financial Ltd  
Merrill Lynch International  
Morgan Stanley & Co International Ltd  
Phibro Futures & Metals Ltd  
Prudential Bache International Ltd  
PVM Oil Futures Ltd  
Refco Overseas Ltd

Saratoga  
Shell International Trading & Shipping Co Ltd  
SEB Futures (a division of Skandinaviska Enskilda Banken)  
Spectron Futures Ltd  
Sudcen (U.K.) Ltd  
Trafalgar Commodities Ltd  
UBS Ltd.

#### TRADE PARTICIPANTS

Accord Energy Ltd  
BG International  
BP Gas Marketing  
Cinergy Global Trading Ltd.  
ConocoPhillips Ltd.  
Duke Energy Int'l Finance (UK) Ltd  
EdF Trading Ltd.  
Entergy Koch Trading Ltd  
ExxonMobil Gas Marketing Europe Ltd.  
Fortum Gas Limited  
Hess Energy Power & Gas Co (UK) Ltd  
Innogy Plc  
NV Nederlandse Gasunie  
Powergen PLC  
Scottish Power Energy Trading Ltd  
Sempra Energy Europe Ltd  
SmartestEnergy Ltd  
Shell Energy Trading Ltd  
TotalFinaElf Gas & Power Ltd

## Appendix 2

# **Guidance Release 2/93 - Proper Markets in Relation to On-Exchange Derivatives (April 1993)**

## **Part 1: General**

### **1. Introduction**

1.1 There are a number of statutory and regulatory provisions whose objective is to ensure the integrity of UK financial markets. These tend to be couched in relatively general terms and little guidance has been given as to what they may imply.

1.2 This guidance has been discussed with the recognised derivatives investment exchanges in the UK (the 'derivatives exchanges'). However, its terms are the responsibility of SIB.

#### Note

In this guidance, SIB uses the expression 'derivatives exchange' to refer to a UK derivatives exchange which it has recognised. The guidance does not use the expression to include any overseas recognised derivatives exchange, where recognition is a matter for Her Majesty's Treasury.

1.3 SIB has separately issued guidance on two related issues, relating to exchange incentive schemes [1], and proper trades [2]. SIB believes that these three pieces of guidance are closely interrelated, and that their effect flows one to another. The acceptability of incentive schemes may influence the propriety of trades which may in turn affect whether or not a proper market exists.

1.4 SIB issues this guidance under section 206 of the Financial Services Act 1986 ('the Act'). The guidance is not itself designed either to be exhaustive, or to have the character of rules or regulations made under the Act. It will be appreciated that only the courts can give legally binding interpretations of the Act.

[1] Incentive Schemes in Relation to On-Exchange Derivatives, Guidance Release 3/92, December 1992

[2] Proper Trades in Relation to On-Exchange Derivatives, Guidance Release 1/93, 1993.

### **2. Importance of clean markets**

The purpose of the Financial Services Act is investor protection. In the past, considerable emphasis has been placed on protecting customers, and particularly private customers, in their dealings with authorised firms. However, an equally important investor protection objective is promoting and maintaining the integrity of markets, and particularly markets operated by recognised exchanges. All investors who deal on such exchanges, whether private or professional, share a common interest in the integrity of their markets.

### **3. Relevance of this guidance**

3.1 This guidance is addressed to the derivatives exchanges. It expands on SIB's view as to the interpretation in this context of the recognition requirement which requires derivatives exchanges to 'limit dealings on the exchange to investments in which there is a proper market' (paragraph 2(2)(a) of Schedule 4 to the Act).

3.2 Whilst many of the points contained in this guidance may be of relevance to the securities exchanges, SIB nevertheless recognises the significant differences between derivatives and securities exchanges and accordingly emphasises that this guidance addresses only derivatives exchanges. In recent years, the tremendous development of new products and volume growth in the derivatives area inevitably have led to significant changes in trading practices, markets and applicable law. Whilst the process of adjusting and responding to change must be ongoing. SIB's aim here is to provide clarification and confirmation of what SIB considers to be acceptable practice in areas of particular relevance to derivatives exchanges.

## **4. Statutory ban on market manipulation**

In the context of this guidance, SIB believes it relevant to record the provisions of section 47(2) of the Act:

'Any person who does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any investments is guilty of an offence if he does so for the purpose of creating that impression and of thereby inducing another person to acquire, dis pose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments.'

## **Part 2: Proper Markets**

### **5. The requirement**

Paragraph 2(2) (a) of Schedule 4 to the Act establishes as a requirement for recognition of an investment exchange that the exchange must 'limit dealings on the exchange to investments in which there is a proper market'.

### **6. Criteria**

With a view to assisting derivatives exchanges in their determination of what is needed to limit dealings to investments in which there is a proper market, SIB is identifying in this guidance certain criteria it believes should be features inherent in a proper market. In so doing, SIB recognises that different derivatives exchanges and their markets have widely different characteristics and accordingly there may well be additional criteria pertinent to particular markets; but SIB believes the points detailed in this guidance are basic criteria which should be common to all markets. SIB notes that derivatives exchanges have a continuing role in ensuring that a proper market is available in each of their contracts and should keep under review the fulfilment of those basic criteria as they apply to each derivatives exchange contract.

### **7. A Market**

7.1 For purposes of this guidance, a 'market' is deemed to be a facility or arrangement organised and regulated by a derivatives exchange for purposes of enabling its members (and, through them, their customers) to execute trades in its derivatives contracts subject to its rules. For the avoidance of doubt, there is a separate and distinct market in each derivatives contract available to be traded on a derivatives exchange.

7.2 A derivatives exchange must prescribe an identified forum or medium of communication through which members who are willing buyers and sellers can transact business in derivatives exchange contracts at mutually agreed prices. Such trades must be in accordance with applicable derivatives exchange rules and be reported to the derivatives exchange.

#### **Note**

Fora or media may include, for example, a physical trading floor, pit or ring, a computerised system, telephone or other communications networks, or some combination of these. Such trading facilities may be provided directly by the derivatives exchange or by independent sources (eg telecommunications).

### **8. Market participation**

There should be a sufficient range of participants in a market as to bring adequate opposing forces of supply and demand to that market.

#### **Note**

Derivatives exchanges have a continuing role in monitoring their markets with a view to identifying and addressing potential abuses eg corners. Vulnerability to manipulation may be affected by a number of factors eg the extent of direct involvement by market participants in a derivatives market, open interest, or the availability of deliverable stock of the relevant underlying product.

## **9. The trading system and access**

Derivatives exchanges must have published rules and procedures establishing the manner in which trades can be entered into between members. They may include processes of open outcry, order execution algorithms in automated systems, and individual negotiations. But in all instances, the trading system(s) should be designed to ensure that all qualified participants (eg members) have equitable access to the market so that market prices can reflect adequately prevailing supply and demand forces in that market. For example, a derivatives exchange 'market' confined to trades which are individually negotiated and not reported to the exchange would be unlikely to qualify to be regarded as a proper market.

### **Note**

The nature of access to the market may vary as between different categories of member (eg floor members and associate members), and different categories of member may be subject to different rules, trading procedures, benefits or restrictions (eg market makers, brokers and locals).

## **10. Relationship with underlying market**

By definition, derivatives products relate to an underlying physical (eg commodity) or cash (eg security or currency) market, or an index or other factor related to them. Accordingly, for proper market purposes, the specifications and terms of derivatives contracts established under derivatives exchange rules should be sufficiently precise as to provide for an understandable relationship between the derivative and the corresponding underlying markets. It is not suggested that there will be, for example, complete price congruence since there are inherent basis differentials between the majority of derivatives and their respective underlying markets; but there should be an understandable relationship between the price of the derivative and the price of the underlying and there generally will be a convergence between these prices as the derivative moves to expiry.

## **11. Market values**

Procedures must be in place for determining a value of a contract at regular intervals (as a minimum, once every business day). Such value should reasonably reflect the prevailing supply/demand forces relevant to that contract.

### **Note**

In active markets where there are likely to be narrow bid/offer spreads, prevailing values should be easily determinable. However, a derivatives exchange must have established procedures for determining a value even in 'thin' markets on at least a daily basis (eg for the purposes of settlement or margin).

## **12. Liquidity**

12.1 In SIB's view, liquidity is normally an important indicator of a proper market. For purposes of this paper, SIB takes liquidity to mean the ability of a market to accommodate transactions of reasonable size at acceptable price spreads in a short space of time. Volume and open interest are useful (although not conclusive) indicators of a liquid market. The greater the volume and open interest, and hence the depth of the market, the greater, normally, is the ability to trade freely and to achieve readily a representative market price.

12.2 However, in SIB's view, an absence of liquidity is not necessarily a sign of a market which is not a proper market. SIB accepts that, for a variety of different reasons, certain markets can be illiquid in comparative terms but nevertheless serve a valid purpose for interested participants; the overriding consideration in SIB's view is that any such (illiquid) market should fulfil the basic identified criteria, in particular that of enabling willing buyers and sellers to transact business at prices which reflect supply and demand. However, SIB would emphasise that derivatives exchanges have a continuing role in reviewing contracts to determine whether a proper market is available, taking into account the basic criteria and the factors peculiar to a particular market. In the course of such reviews, SIB would expect derivatives exchanges to take into account, inter alia, the size of trades capable of being executed and the bid/offer spreads typically available.

### **Note**

Whilst illiquid markets can serve a legitimate purpose, they are likely to be unsuitable for inexperienced investors. It is in SIB's view the responsibility of firms to consider the suitability of such (illiquid) investments for such investors and to ensure compliance with the relevant rules of their authorising regulator.

## **13. Additional requirements**

Schedule 4 to the Act identifies other recognition requirements separately from the 'proper market' requirement. These include 'orderly markets' (paragraph 2(01)), 'price transparency' (paragraph 2(02)(b)), 'ensuring performance'

(paragraph 2(04)), 'transaction recording' (paragraph 2(05)), and monitoring and enforcement' (paragraph 3(01)). Whilst these are identified separately in Schedule 4, SIB believes that all of them can be relevant to the achievement of a proper market, although each has broader implications for investor protection and market integrity.

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