



## LONDON METAL EXCHANGE

28 July 2004

M. Fabrice Demarigny  
The Committee of European Securities Regulators  
11-13 avenue de Friedland  
75008 PARIS  
FRANCE

Dear M. Demarigny,

### **Call for Evidence: second set of mandates - MiFID**

The London Metal Exchange is a UK Recognised Investment Exchange; as a regulated market, it regulates the world's premier marketplace for the trading of exchange-traded futures and options on non-ferrous base metals. Its membership comprises investment firms, credit institutions, and affiliates of credit institutions. Its users are knowledgeable, experienced, wholesale and industrial users, and professional funds that use the LME to hedge, trade and source base metals traded on the exchange. The Official Prices published by the LME are world reference prices for the metals in question.

As a commodity derivatives exchange, the LME welcomes the opportunity to respond to the Call for Evidence from CESR on the second set of mandates from the Commission on the Markets in Financial Instruments Directive ('MiFID'), particularly as they affect commodity derivatives. We restrict comment to issues raised in paragraphs 3.1, 3.3, and 3.6.2 due to their direct and immediate impact on trading in those financial instruments.

#### **3.1 List of Financial Instruments (Article 4 - Annex 1, Section C)**

##### ***(1) A definition of commodity***

Traditionally, the definition of commodity applied to homogeneous interchangeable articles or raw materials such as metals, softs (or agricultural), and energy products capable of being bought or sold and delivered. Given their nature, it is possible to package such products into fungible contracts of standardised quality and quantity suitable for trading and delivery on futures and options markets. Examples of traditional commodity derivatives admitted to trading on markets range from coffee to tin to frozen orange juice to greasy wool to crude oil. There are hundreds if not thousands of such products traded in standardised form as commodity derivatives throughout the world. The number and variety of these

grows virtually daily, particularly as instruments, goods and services are packaged, or commoditised, so that it becomes easier to hedge them or trade in them.

Factors leading to the commoditisation of instruments, goods, and services include ease of replication, barriers to new entrants being low, and existing producers holding little pricing power. Anything with such a profile will potentially attract over time a proliferation of new providers replicating the instrument, good, or service, with only branding or marketing distinguishing one product from another. In effect, the basic instrument, product or service has become a commodity. Foreign currency exchange rates, electricity, gas, computer chips, and bandwidth are only a few examples of instruments, goods, and services commoditised in this way, and, hence, found suitable for trading as futures and options either on- or off-exchange. It is evident that the boundaries between financial products and services and traditional commodity products and services are narrowing. Arguably, this began as far back as the Middle Ages, when bankers transformed the financial markets on realising that money is simply a fungible commodity.

Due to the proliferation of instruments, goods and services suitable for treatment as commodities or which are capable of commoditisation it appears to be virtually impossible to define absolutely the term 'commodity.' To paraphrase the description of an elephant: it is far easier to recognise a commodity than to define it. Accordingly, CESR should consider making this known to the Commission, or, alternatively, it should provide a definition that is sufficiently broad in scope to ensure that it does not stifle innovation. Although we favour the former approach, if the Commission is adamant that CESR must supply a definition, the following wording might provide a basic idea for CESR to develop in consultation with industry.

*A commodity is a physical good or element typically produced in agriculture, energy exploration or mining, usually standardised or subject to industry grading or other classification, that can be the object of commercial transactions. It includes, but is not limited to, any index, rate, security or physical commodity that is or could be the underlying instrument or price determinant of a futures contract or other instrument.*

In effect, the definition of commodity should be sufficiently wide to encompass anything that one can trade, excluding financial instruments, as defined in C1-C4 and C8-C9 of Annex 1 to MiFID.

The LME would remind CESR that several directives include the words commodity or commodities but without defining the term. CESR and the Commission will need to consider the implications of defining the term for the purposes of MiFID.

*(2) The conditions under which an option, future, swap forward rate agreement or other derivative contract related to commodities (which can be physically settled and is not otherwise covered by Section C.6) should be determined not to be for a commercial purpose.*

It is perhaps easier to provide advice on the conditions or characteristics that might aid the determination of when the use of derivatives is for a commercial purpose. These conditions, which need not all be present for every transaction, include:

- The parties to the agreement intend to make or take delivery at the time of entering into the agreement, although entering into an offsetting

arrangement to close out the initial transaction might be acceptable, particularly on an occasional basis;

- Delivery is for a spot or forward date of less than seven days, although the delivery period until settlement for spot dealings will vary depending on the commodity and, possibly, country or country of origin, and commercial entities might wish to enter into agreements for forward dates well beyond seven days; note that traditionally many commodities traded on regulated markets have a three-month contract, which reflected transport time for delivery of, say, copper from Chile to the United Kingdom;
- At least one of the parties to the transaction is a producer or merchant or user of the underlying commodity;
- The terms of the contract are agreed bilaterally, but might include standard industry-wide clauses, or clauses requiring the quality to be equivalent to that traded on a regulated market and for the settlement/delivery price to be by reference to the price of a financial investment dealt on a regulated market;
- There is no margin payable, although it is necessary to note that those engaging in commercial transactions might require margin to reduce counterparty risk, as will a clearing house ensuring performance of OTC dealings in commodity derivatives;
- A recognised clearing house does not ensure performance or delivery, although it is necessary to note that clearing houses are increasingly clearing over-the-counter (OTC) derivatives transactions; and
- The option, future, swap forward rate agreement or other derivative contract related to commodities does not take place on a regulated market or MTF.

*(3) The conditions (other than cleared and settled through recognised clearing houses or subject to regular margin calls) for considering when a derivative contract of the type included in Annex 1 Section C7 has the characteristics of other derivative financial instruments.*

Additional characteristic of derivative financial instruments relating to commodities that can be physically settled but which are not included in Annex 1, Section C6 might be that they have standardised terms and conditions with respect to quality and quantity, that they have standardised settlement terms, and that they are subject to legally binding netting agreements. However, we would once again urge CESR to consider this only as a basic idea that it needs to develop in consultation with industry.

*(4) The definition of climatic variables, freight rates, emission allowances, inflation rates, official statistics*

In the same way that it is easier to recognise an elephant than to describe one, so it is with derivatives contracts relating to climatic variables, freight rates, emission allowances, inflation rates, and official statistics or to the underlying 'instruments'. Consequently, it might be more logical to aid recognition of the 'instruments' by providing very broad guidance on their suitability as the underlying for derivative contracts. This could depend on:

- The availability of historical information on price/ index levels, or data used in the construction of the relevant indices or levels;
- The transparency/ disclosure to investors/ the public of the construction of the underlying and its base level;
- The pricing basis of the underlying, including the independence (or otherwise) of those constructing or calculating or pricing the underlying;
- Frequency of publication of the level of the underlying; and
- (For the derivatives) the availability of contract terms, conditions, and performance obligations, and derivative prices.

*5) Whether there are, at this time, other categories of assets, rights, obligations, indices and measures not otherwise mentioned in Section C, where contracts relating thereto should be determined to fall within Section C10. CESR should explicitly detail those categories.*

As mentioned in the definition of 'commodity', it is impossible to control the commoditisation of goods and services and, hence, impossible to define absolutely the term commodity. Similarly, it appears impractical to try to detail explicitly what other categories of derivatives contracts could be available now or at a future time relating to assets, rights, obligations, indices and measures. Those known to exist presently seem to fall within C4-C10, but, subject to the ingenuity of traders and the needs of hedgers, conceivably new derivatives will emerge with the creation of new assets, rights, obligations, indices and measures, or the commoditisation of existing assets, rights, obligations, indices and measures.

We suggest that CESR advice to the Commission should be that competent authorities must ensure that for the purposes of C10, any category of asset, right, obligation, index and measure that might fall within 'other category of derivative contract', other than when for commercial purposes, must comply with the requirements of Article 40, particularly 40.1 and 40.2.

### **3.3 Conduct of business rules (Article 19)**

When formatting its advice to the Commission, we urge CESR to recall the acknowledgement made in the Explanatory Memorandum to the draft ISD2 text published on 19 November 2002 that the extension of the ISD to commodity derivatives must take account of features specific to the instruments, as well as the predominantly "wholesale/professional" nature of market participants. Retail clients are not a particular feature of the commodity markets, and professional clients are typically producers, processors, merchants, or consumers of the commodities, meaning that often their knowledge of the underlying market is greater than that of brokers and traders at investment firms. They will deal frequently with more than one investment firm. In addition, professional clients who use derivatives markets to hedge, trade or source commodities, are knowledgeable, experienced, and fully capable of assessing the risk and rewards of dealing in the markets.

Accordingly, we ask CESR to avoid offering advice to the Commission that results in the imposition of unnecessarily onerous obligations on investment firms that their clients neither appreciate nor require.

### 3.6.2 Eligible counterparties (Art. 24.3)

Currently, clients of investment firms active in the commodity derivatives markets in the UK usually receive the client classification of either 'intermediate customers' or 'market counterparty' depending on factors such as turnover, balance sheet size or number of employees. Various conduct of business rules concerning, inter alia, best execution and risk disclosure do not apply to customers classified as such. Investment firms must conduct appropriate due diligence under the 'know your customer' (KYC) requirements to ensure that their customers receive appropriate categorisation. KYC ensures that regulatory protections apply to those classes of client needing them most, while allowing an appropriately 'light-touch' approach for others.

Users of commodity derivatives markets vary enormously in size, but that does not mean that they are not experienced or lack understanding of the market and risk; it is their appreciation of the latter that brings them to commodity derivatives markets to hedge their exposure. Hence, we urge CESR to recommend quantitative thresholds that are reasonable. We suggest a balance sheet total of no more than 10 million euros and a net turnover of no more than 25 million euros before a commodity derivatives client can opt for treatment as an eligible counterparty. The KYC rules should avoid inappropriate classification.

#### General

Commodity and commodity derivatives markets are different to securities markets; customers are commonly from a commercial/ industrial background. Instruments listed for trading, accepted practices, and information needs and services of customers have developed in response to the demands of the customers. They are very much customer-driven markets. The LME stands ready to assist CESR in whatever way it can if it wishes to avail itself of industry expertise when deliberating on advice to give to the Commission. Our recommendation is for CESR to establish a 'commodity consultative group' for this purpose.

Should you or your colleagues wish to discuss the comments made by the LME you can contact me by telephone (+44 (0)20 7264 5675), by fax (+44 (0)20 7264 5513), or by e-mail ([neil.mcgeown@lme.com](mailto:neil.mcgeown@lme.com)).

Yours sincerely



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LME Regulation & Compliance