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Consultation paper on CESR/CEBS technical advice to the European Commission on the review of commodities business

ISDA-FOA-EFET response

5 August 2008

I Introduction

This paper is in response to the CESR/CEBS consultation paper, published on 15 May 2008, on the review of the commodities business, expressing views jointly held by the members of ISDA, the FOA and EFET. These organizations have been cooperating as part of the 'Commodity Derivatives Working Group' (CDWG), with the aim of drafting this joint response. This working group, together with the Commodity Firms Regulatory Capital Working Group (CFRC), which was set up to discuss the prudential treatment of commodity firms in the EU, provides an international industry platform for discussing the regulatory treatment of commodities and commodity firms active in the EU. The members of the association working groups are mainly risk officers, compliance officers, and lawyers from major commodity firms active in the EU, with expertise in the field of credit, market or operational risk.

Where we use the term 'CDWG' in this submission, we are referring to the view jointly held by each of these associations regarding the Call for Evidence.

ISDA represents participants in the privately negotiated derivatives industry and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

The FOA is the industry association for 160 international firms and institutions which engage in the carrying on of derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector.

EFET works to promote the development of a sustainable and liquid European wholesale market in electricity and gas, as well as in related physical commodities and derivative contracts. EFET is complementary to existing industry organisations in Europe as it is solely dedicated to energy trading issues, and lists over 100 firms as members.

The questions in the CESR/CEBS consultation paper relating to prudential regulation of commodity firms have been addressed by the CFRC, a joint task force set up by ISDA, EFET and the FOA, working alongside the Commodity Derivatives Working Group, focusing specifically on the prudential treatment of commodity firms in the EU. The CFRC comprises 21 commodity firms active in the European energy and metal markets. The CFRC does not purport to represent soft commodity traders and continues to recommend that the Commission and CEBS contact them or their trade bodies directly.

Firms and associations who have taken part in the CDWG and CFRC work include:

1. Accord Energy
2. Actogas
3. Amalgamated Metals Trading
4. Becker Buttner Held - Energy Commodities Traders Group
5. BP
6. Clifford Chance
7. ConEnergy - Energy Commodities Traders Group
8. ConocoPhillips
9. e&t Energie Handelsgesellschaft
10. E.ON Sales & Trading
11. ED & F Commodity Advisers Limited
12. EDF
13. EFET
14. Syneco Trading
15. Electrabel
16. EnBW Trading
17. Endesa
18. European Energy Exchange
19. FOA
20. Gaselys
21. Gide Loyrette Nouel
22. Hess Energy Trading Company

23. ISDA
24. Koch Metals
25. Nuon Energy Trade & Wholesale
26. RWE Supply and Trading GmbH
27. Stasco (Shell International Trading and Shipping Company Limited)
28. Total
29. Totsa
30. Triland
31. Vattenfall
32. Vitol

i. II Executive Summary

ISDA, the FOA and EFET welcome the ongoing consultation of market participants and other interested parties by the European Commission and financial regulators, and is pleased to make a contribution to this CESR/CEBS consultation paper.

We maintain that any new regulation applying to commodity firms should only be proposed after clear evidence of a market failure has been identified. We do not believe that any evidence has been produced to suggest there is a market failure requiring regulation under MIFID of own account trading by commodity firms with wholesale, sophisticated market participants, nor regarding financial systemic risk in relation to commodity firms.

The CDWG continues to believe that the current review of regulation of commodity and exotic derivatives should result in a framework based along the following lines:

- The CDWG supports replacement of the second limb of both article 2.1(i) and article 2.1(k) with a single exemption for firms (other than operators of MTFs or regulated markets) whose main business consists of dealing on own account in relation to commodities and/or commodity derivatives or other non-financial derivatives contracts. The aforementioned exemption should only apply to the firm's activities when dealing on own account in commodity and other non-financial derivatives with a defined class of *'wholesale market participants'*. Investor protection concerns built into MIFID conduct of business rules are not pertinent in markets and dealings which are sophisticated and wholesale in nature, with no direct retail involvement.
- Application of an 'appropriate' licensing regime for activities of commodity firms other than own account trading.
- The 'Alternative Approach', based primarily on internal risk management models and disclosure (rather than Pillar 1 minimum capital requirements), should apply to firms' activities falling within the scope of the 'appropriate' licensing regime mentioned above. Commodity firms have major concerns about the potential burden of capital requirements applied to them in event of a MIFID licensing requirement, whatever the limits of the final MIFID regime. The Alternative Approach should be considered as the minimum standard for commodities firms where Pillar 1 capital requirements are considered disproportionate to the risks and where the costs are likely to significantly outweigh the regulatory benefits. A disproportionate capital regime for commodity firms will have a disastrous disastrous effect on commodities markets.
- The exemption from MIFID should be applied in a harmonized way throughout the EU. This would deliver harmonized implementation, benefiting the EU single market, delivering economies of scale for market participants and greater competition. It would also limit the scope for what the CESR-CEBS paper calls 'regulatory arbitrage' within Europe.
- We believe that the specific nature of participants in commodities markets should be considered in defining the *'wholesale market participants'* mentioned in the first bullet above – without reference to the current MIFID client categories. We do not believe that MIFID professional investor classification, for example, fits with the profile of these

markets (i.e. sophisticated participants in these markets, who would prefer not to have retail investor classifications under MIFID may not fulfil the qualitative criteria under Annex II MIFID.

- We do not believe there is any call for amendment of the current definitions of financial instruments, insofar a*s they apply to commodity deriv*atives - which were the subject of considerable consultation with the industry. These definitions distinguish adequately between commodity derivative dealings which fall within MIFID and physical commodity dealings, which do not fall within MIFID.
- We see no grounds for the imposition of new transaction reporting requirements on commodity derivative markets, nor for imposition of new transparency requirements in relation to commodity derivatives transactions. The CDWG is not aware of any evidence to suggest there is a regulatory or market failure concerning market integrity in commodity derivative markets which necessitates new legislation. For the purpose of commodity derivative trading, the existing framework of position reportin*g and accountability, market ov*ersight, record keeping obligations and powers of intervention exercisable by regulatory and market authorities provide a sound framework of regulation.

We would be happy to discuss any of these comments further and or hear your views on our response, and to arrange this please contact either Roger Cogan (at ISDA in Brussels) or Simon Andrews (at the FOA).

III Response to Questions

1) In practice, what proportion and/or amount of *OTC commodity derivative* transactions are financial instruments falling within the *MiFID* and what proportion are spot? (a breakdown in terms of the underlying would be helpful)

It is not possible to collate meaningful data in response to this question across either a single industry or, more significantly, across multiple commodity markets.

The CDWG would make the general observation that spot traded volume in commodity trading markets is negligible compared to the volumes in forward markets.

ISDA, the FOA and EFET refers CESR/CEBS members to the recent ESME report which provides some indication of the nature and volume of the exchange-traded commodity derivative, OTC commodity derivative and physical markets (including spot markets) – as well as highlighting the complexity of isolating such data in these markets.

2) Do you agree that the level of direct participation by unsophisticated investors is mainly limited to corporate clients such as producers or wholesale distributors (with a lack of experience and knowledge in derivatives markets but not in trading in physical *commodity markets)*, that participation by private clients is very low, and that most other participants in *commodity derivatives markets* are sophisticated firms?

The CDWG believes it would be wrong to label all corporate clients such as producers and wholesale investors as 'unsophisticated' given the key role that commodity derivatives play in the risk management strategies of many real economy companies.

There is little or no direct participation of retail clients in commodity derivative markets (where retail investors are involved, this involvement is intermediated by regulated professional investors, who are required under MIFID to look after the best interests of their customers). We do not believe that private client involvement in commodity markets is a materially significant factor in commodity derivative markets.

Commodity derivative markets are overwhelmingly characterized by the involvement of sophisticated, wholesale counterparties.

In consideration of the volatile nature of commodity derivative markets, the CDWG would not support regulation facilitating the direct involvement of retail and private investors in these markets. Private investment in commodity markets is best managed via sophisticated professional investors.

3) What informational advantages persist in *commodity derivatives markets*, and in particular to what extent do those also active in the underlying physical market have informational advantages?

Counterparties involved in the underlying physical market at times may have informational advantages over those involved only in trading of derivatives on commodities. We note the observation of the UK Treasury and Financial Services Authority (in their discussion paper of

December 2007 on this issue) that this can be seen as a 'natural economic 'rent' accruing to firms investing in the underlying market.

Given the wholesale, sophisticated nature of participants in commodity derivatives markets, characterized by a high degree of awareness of informational asymmetries, and high levels of expertise, we believe that participants are well placed to make judgments as to their involvement in these markets.

The CDWG notes that, for the purposes of electricity and gas markets, the 3rd Energy Package proposes new transparency requirements on supply undertakings e.g. concerning forecasts of demand and supply and costs for network balancing, and in relation to gas stocks. The CDWG supports these requirements, as a means of informing the consideration of all participants in derivatives markets.

We also remind CESR and CEBS that there are many commercial sources of information available to market participants, on an equal cost basis (e.g. Platts, Bloomberg, Reuters etc).

The CESR/CEBS paper refers to variations in informational gaps in the commodity derivatives sector, listing, in descending order, different types of participants in commodity derivative markets, possessed of descending levels of knowledge and experience, beginning with firms commercially active in the underlying physical commodity derivative market, and ending with individuals. The CDWG would make the following observations concerning this list:

- Recognition should be preserved of the need for firms 'active in the underlying physical commodity market' to manage effectively risks arising from such activity. We also remind you that the MAD definition of insider information for commodities business regulates, to a large extent, the scope for abuse of such information;
- Dealer financial institutions play a key role in commodity markets, in particular in their capacity and willingness to provide liquidity (e.g. by taking long positions), enabling commodity firms to hedge. We believe that these firms are possessed of adequate levels of sophistication and knowledge to do this;
- Pension funds taking positions in commodity markets most commonly do so through professionally managed commodity derivative index funds. These funds are subject to limited levels of volatility (given that any index fund is by its very nature, diversified), and information asymmetries of the type described in this section of the CESR/CEBS paper will only have a limited impact on the movement in value of such indices. We would also add that investment in commodities is itself often part of a wider diversification strategy by these funds (commodities, as an asset class, perform well, when other asset classes may not be performing that well).

The CDWG notes that the CESR/CEBS paper recognizes that market participants do not appear to be deterred from participating in OTC derivatives by what it terms the 'relatively low transparency of OTC commodity derivatives markets' and that discussions with these participants in these markets suggest that they 'do not have any significant issues with transparency in commodity derivatives markets'. The paper suggests that there is no market failure in this context.

We question the suggestion (found in the CESR/CEBS paper) of any regulatory failure regarding transparency of OTC commodity derivative market. There is no evidence to suggest that, as the paper says, 'low transparency….may deter optimal levels of market participation and increase the risk premiums demanded by investors, raising the cost of capital.'

On the contrary, we believe that the growth in volumes of commodity derivatives trading, both on-exchange and OTC, suggests that these markets are becoming increasingly efficient. We believe that new mandatory transparency requirements in relation to commodity derivatives could actually reduce the attractiveness of commodity derivative markets to commercial participants and liquidity providers (who may find it difficult to sell off a typical long position taken via a bilateral contract with a producer in the market thereafter).

The CDWG believes in the concept of 'optimal transparency' and that market transparency is not an end in itself (rather, in specific types of market, it may be a means towards an end (i.e. market efficiency)).

We would also remind regulators that OTC commodity derivative market transparency requirements may actually create confusion when so many of these transactions are customized and not directly comparable with other instruments.

Lastly, it is not actually accurate to refer to 'low' levels of transparency in OTC commodity derivative markets. Market participants can avail themselves of many different sources of information in commodity derivative markets, including exchange websites, broker websites and commercial data providers such as Platts and Bloomberg. In these circumstances, the CDWG questions whether mandatory transparency requirements would add any value in these markets.

4) Do information asymmetries in *commodity derivatives markets* lead to mis-selling concerns, or to other concerns about potential client detriment?

As mentioned above, we question the extent to which information asymmetries in commodity derivatives markets point to a market or regulatory failure.

We recall that retail investment in commodity derivatives takes place via professional intermediation.

We understand, from our reading of the CESR/CEBS paper, that this question primarily addresses possible mis-selling to 'unsophisticated investors' such as 'corporate producers and wholesale distributors.'

The CDWG is not aware of any evidence that there is problem with mis-selling of commodity derivatives to such investors, and underlines that no such evidence has been presented in the CESR/CEBS consultation paper.

In addition, the CDWG would like to highlight that such investors may be classified as retail investors under MIFID investor classification rules, and as such, would be subject to a higher standard of conduct of business protection (suitability testing, best execution rules e.g.). The CDWG believes that MIFID investor classification rules are too stringent for the purposes of these investors, imposing disproportionate and unnecessary levels of investor protection rules and associated administrative costs, and in some cases preventing or delaying access to hedging and risk management products. Elsewhere in this response we outline how we believe these rules should be re-considered.

Lastly, we remind CESR/CEBS that OTC commodity derivatives (where the CESR/CEBS paper infers that information assymetries exist) are bilateral contracts, where market participants are free to agree or negotiate the terms of these contracts.

5) Do you have any transparency-related concerns relating to the trading of non-electricity and gas *derivatives*? If so, in which markets and why?

The CDWG does not have any transparency-related concerns relating to the trading of non-electricity and gas derivatives.

6) Do you have evidence of informational asymmetries in *commodity derivatives markets* in relation to market abuse?

The CDWG has no such evidence.

The CDWG is aware of the concerns of some financial institutions participating in commodities markets, who believe that there is an insufficient 'regulatory grip' over commodity derivatives trading away from regulated exchanges, particularly in relation to the actions of less-regulated, non-listed market participants (see LIBA submissions to previous consultations). It is the understanding of the CDWG that these concerns do not relate to the actions of the type of upstream commodity firms that make up the CDWG.

The CDWG member commodity firms are not convinced that there is any market failure, or behavior (by 'less-regulated, non-listed market participants') that requires regulatory action of this nature.

We remind regulators that legitimate risk management and risk mitigation activity should not be prohibited (or discouraged) in legislation. We also recall that inside information in commodities trading is already addressed in the Market Abuse Directive.

We also remind CESR/CEBS of the previous findings of CESR in its 'initial assistance' to the European Commission, provided in 2007, that market discipline plays a key role in ensuring a sound level of market integrity in commodity derivative markets: any counterparty engaging in behaviour at odds with market integrity would find prospective counterparties unwilling to transact with them, for this reason.

Lastly, the CDWG reminds regulators that it supports the disclosure of more information in the underlying electricity and gas markets – for example on fundamental data in relation to the use of infrastructure (the type of information that should be disclosed is detailed in our response to Question 3).

The CDWG associations will address this issue (for the purposes of electricity and gas markets) in more detail in the context of the consultation on the recently published draft CESR/ERGEG advice to the European Commission proposing a bespoke EU Market Abuse framework for electricity and gas markets.

7) Please provide any information you may have on the levels of lending and trading exposures between *specialist commodity derivative firms* and *institutions*.

This question once again addresses the potential for systemic risk from the activities of specialist commodity firms seeking further information on the possible interconnections between sectors. We note that in CEBS' previous work submitted to the European Commission it was concluded that the systemic risk posed by specialist commodity firms was low in comparison to that posed by financial firms, and we agreed with this conclusion. The market failure analysis conducted by CEBS went on to conclude that systemic concerns were "limited and contained". It is important that any advice to the EU Commission with regards to the prudential regulatory policy options with respect to specialist commodity firms is consistent with these conclusions.

The draft CESR/CEBS report suggests that counterparty credit risk resulting from trading activity is more material than credit risk arising from straight lending activities, and therefore contributes more to linking market participants across sectors and possibly creating systemic risk. However, there is no evidence presented in the paper to suggest that this is the case or that leads CEBS to this conclusion.

Market participants in specialist commodities markets vary enormously in size and character, and this is well reflected in the cross section of member firms participating in our work on this issue (see the list of firms supplied earlier in this paper). The lending and trading activities, together with the risk management techniques adopted also vary widely across the sector, however, the CEBS draft report seems to assume that all participants engage in trading activities in types of instruments other than commodities derivatives (including interest rate and fx derivatives). Whilst this is often the case, this does not always hold true. Furthermore, in arriving at a conclusion, CEBS seems to ignore the potential benefits of risk mitigation techniques which are standard among some specialist commodities firms. These include applying standardized netting and collateral provisions, common in OTC derivative contracts, which together help to significantly reduce counterparty credit risk.

8) What level of risk do *specialist commodity derivative firms* pose to the financial system?

We agree with the conclusion in the draft report in paragraph 102 that systemic risks generated by specialist commodity firms appear to be relatively low compared to the systemic risks generated by banks and ISD investment firms. The core business of specialist commodity firms is not in financial trading or in other forms of investment business, but in physical markets so that their impact on the financial system is less because their exposure to the financial system is less. We also agree with the observations in paragraph 97 which says that there have been no cases in which interconnections between specialist commodity derivative firms and other financial institutions have led to significant financial instability. Therefore, as we have stated above, any regulatory policy options being considered should be consistent with these conclusions and be both proportional and appropriate given the low levels of systemic risks identified.

9) To what extent does the level of systemic financial risk posed by *specialist commodity derivative firms* differ from that generated by banks and *ISD* investment firms?

While we recognize that in the course of trading in commodity derivatives member firms face many of the same risks as banks and investment firms, it is not true to assume that the financial impact of failure by a commodity firm will be the same as an equivalent failure by a financial institution.

The key differentiating factor between banks and all other firms dealing in commodity derivatives is the level of systemic risk. This risk stems from the unique nature of banks' balance sheets and, more importantly, the pivotal role that banks play in the payment system. For example, the news of one bank failure can create a 'bank-run' or panic in otherwise solvent banks. Inter-bank markets and transactions, particularly through the payments system mean that as one bank fails, the effects of its failure are rapidly transmitted to other banks. The important role that banks have economically, therefore, means that the failure of a large bank could involve significant disruption to the wider economy. Specialist commodity firms do not pose similar systemic risks.

This lack of systemic impact on the financial system, as recognised by CEBS, renders a minimum banking capital charge an inappropriate method of regulating specialist commodity firms.

10) Do the risks generated by energy-only investment firms differ materially from those posed by investment firms engaging in other commodity derivative activities/services? If so, how do they differ?

We understand "energy-only" investment firm to mean firms only investing in oil, gas, coal, electricity, bio-fuels. However, we note that some of these types of firms are also active in so-called "exotics", such as emissions allowances, which are not included in the definition of "energy-only" investment firms outlined in the glossary to the CESR/CEBS paper. Counterparties in these markets include electricity producers, generators, distributors, large industrial consumers and commercial users, storage operators, refiners, retailers, traders, investment firms, end users, and banks. Risks for each type of "energy-only" investment firm will therefore vary.

The CRD capital requirements for settlement and counterparty risks were not designed with specialist commodity firms' practices in mind and, as a result, may not be appropriate for such firms. This could result in disproportionate capital requirements for these firms, since they have dramatically different settlement practices and, possibly, risk implications. For these firms the settlement risks in these markets are very different from the settlement risks facing investors in other markets. For instance, settlement terms are generally longer for oil and energy trading firms, compared to the metal traders. Therefore it would not be appropriate to impose the same type of capital requirements on energy and oil market participants for, say, settlement risks, as those imposed on banks.

Due to the heterogeneous nature of all commodities firms, whichever regulatory framework is applied will need to be scalable and proportionate to the risks posed by each regulated entity.

11) Do you have any transparency-related concerns relating to the trading of non-*energy commodity derivative*s, and, if so, in which markets, what are the concerns, and what solutions could be applied?

The CDWG does not have any transparency-related concerns relating to trading of non-energy commodity derivatives, and does not believe that sufficient evidence of a market failure has been presented to justify imposition of mandatory transparency requirements (in commodity derivatives markets) in this regard.

12) Do you believe that for non-electricity and gas *derivative*s contracts, the transaction reporting requirements in the *MiFID* support market regulation? If so, can you explain why you think they do?

The CDWG believes that the hard-fought compromise on MIFID transaction reporting, including for MIFID-scope regulated exchange-traded commodity derivatives, adequately supports market regulation.

Regulation of markets should ensure that markets are competitive and efficient, and that regulation delivers aimed-for tangible benefits. Extension of transaction reporting beyond the current limits defined in MIFID would create an unwelcome extra burden on participants on OTC commodity derivative markets, acting as a disincentive to their ability to freely hedge risks, or provide liquidity, in these markets. This could limit participation and efficiency in these markets.

The CDWG also questions whether any tangible benefits could be obtained by imposition of transaction reports for every OTC commodity derivative transacted, given the bespoke, customized nature of these transactions (with wide variations in the terms of these contracts). Effectual analysis of these reports would, we believe, require a much greater investment of manpower and expertise by regulators than they may realize.

We note the difficulties encountered in reaching the compromise on transaction reporting for MIFID-scope transactions, and are wary of any suggestion of imposition of transaction reporting requirements for OTC commodity derivatives.

13) Do you have any evidence on potential problems, and if so, on the scale of these problems, that are posed by current client categorisation rules?

19) Do you believe that there is a case for changing the client categorisation regime as it applies to *commodity derivative*s business? If so, do you have any evidence on the scale of the problem or potential problem posed by the existing rules?

Current MIFID client categorization rules penalize both commodity firms and, indirectly, potential clients. Many commodity market clients are small yet experienced firms who fail to meet the strict criteria for professional clients in MIFID yet are considered by market participants, and would consider themselves, to be experienced in their respective markets and in no need of retail client levels of protection.

Commodity firms themselves are dissuaded from accepting as new clients firms which would be categorised as ‘retail’ under MIFID due to the additional regulatory burden that they would thereby incur. This limits the potential for growth within commodity markets, and hinders the growth of liquidity in illiquid markets.

Many of these potential clients are producers of the underlying commodity who suffer as they lose the ability to effectively hedge their physical positions. In cases where a client has been grandfathered by one broker as a professional client yet would be considered a retail client for any new broker the current client classification rules serve to lock clients into existing relationships with brokers and so limit the ability of the market to dictate the success or failure of given firms in response to differences in client service.

The test requiring a professional client to undertake at least ten trades per quarter is indicative of the extent to which the current MIFID requirements do not adequately reflect the interests and operating practices of commodity and other market participants.

These problem have been largely masked so far by pragmatic transitional arrangements which have allowed existing pre-MIFID clients to be “grandfathered” and treated as professional clients or ECPs.

Firms participating in the CDWG are seeking to provide information in support of this position as soon as possible, but note that this information was not possible to collect and collate before the response deadline for this consultation paper.

14) Do you have any evidence that regulation according to the main business of the group may cause competitive distortions?

We have no evidence of regulation applied to the main business group causing competitive distortions.

15) Do you agree that full application of *CRD* capital requirements to *specialist commodity derivative firms* is likely to impose a regulatory burden that is misaligned with their potential systemic impact?

Yes we agree. Full application of the CRD would demand significantly higher capital levels than specialist commodity derivative firms currently hold. In line with the conclusion of the market failure analysis, this may be considered to be an excessive regulatory burden misaligned with the potential systemic impact.

Furthermore, applying the same prudential treatment to all firms runs the risk of the different nature of activities, externalities and information asymmetries associated with the firms belonging to different categories not being taken into account.

Such an application could result in disproportionate and risk-insensitive capital increases, causing market exits and therefore externalities to the economy as a whole. Additionally, the cost of holding this capital would be reflected in higher prices for consumers. It may also cause firms to relocate to other non-EU countries, while fewer market participants are likely to reduce the benefits of competition.

16) Do you believe that full application of *CRD* large exposure requirements to *specialist commodity derivative firms* is likely to impose a regulatory burden that is misaligned with their business and their potential systemic impact?

Yes, we agree.

We note that the European Commission's failure to include in recent amendments to the Large Exposures section of the CRD the recognition of any additional physical collateral other than commercial real estate, such as actively traded physical commodities, making the regime even less relevant for our member firms. Prohibition of the use of physical collateral would have a significant detrimental impact on commodities firms required to apply in full the CRD large exposures requirements.

17) Do you believe there is a potential for regulatory arbitrage? If so, can you provide evidence?

The CDWG is aware of a number of examples of commodity firms either moving to third country jurisdictions, or to 'other' EU Member State jurisdictions where they offer a more competitive regulatory environment. We believe this underlines the importance of the outcome of the MIFID/CRD commodities review delivering a harmonized, appropriate and competitive regulatory framework for commodity firms involved in trading of commodity derivatives.

The CESR/CEBS paper frames this question with reference to the possibility of commodity firms being able to 'cherry-pick' between being subject to or being exempted from regulation (where a subset of market participants is regulated).

The CDWG believes that regulation should be applied in a manner appropriate to the real risks and activities of the regulated/exempted firms.

We remind the CESR/CEBS working group that the CDWG favours the idea that commodity firms exempted from regulation should be able to engage in own account trading with a defined class of 'wholesale market participants' throughout the EU. In this context, we stress that this exemption should only apply for firms engaging only in own account-trading with these 'wholesale market participants'. We do not advocate an exemption for firms providing investment services (we observe that there is sometimes confusion as to what this term implies) to 'clients', nor do we call for provision of an exemption for any transactions executed with 'retail' investors. We believe that trading activities falling outside the scope of the exemption we support *should* be subject to an appropriate MIFID regime.

The CDWG would like to stress that ensuring full and consistent application of such an exemption throughout the EU would limit the scope for regulatory arbitrage.

18) Do you believe that the application of the *MiFID* organizational requirements support the intended aims of market regulation when applied to *specialist commodity derivatives firms*, or *commodity derivatives* business? If not, what aspects of the organizational

requirements do you believe do not support the aims of market regulation when applied to such firms and why?

The CDWG is generally concerned that MIFID is tailored specifically for securities and financial derivatives markets and as such fails to adequately address the peculiarities of commodities markets in general and the specific features of markets in given commodities. Insofar as market participants in commodities markets are mostly traders, producers or professional users of the underlying commodity, or seeking to hedge commercial or business risks, they do not require the same degree of protection from financial regulation as they pursue their commercial objectives by entering into transactions.

The CDWG supports an exemption from MIFID for own account trading by commodity firms with a defined set of wholesale market participants. The CDWG believes that this set of wholesale market participants should be defined on the basis of consideration of the nature of commodity derivatives business – and that the existing client categorisation definitions in MIFID should not necessarily be a point of reference in this context.

20) Do you believe that the conduct of business rules in the *MiFID* effectively support the aims of regulation with respect of *commodity derivative*s business? If not, can you explain why and in what respects, and whether your response is contingent upon the client categorisation definitions applied to *commodity derivative*s business?

The MIFID conduct of business rules drawn up as they were with financial market participants in mind, do not reflect the experience of smaller participants in commodity markets. ISDA supports application of MIFID conduct of business rules to private retail clients. As mentioned, before, however, we believe that there are many participants in commodity markets which are currently classified as 'retail' which do not want to be, and should not be, classified as such.

21) Do each of the following elements of the criteria for determining which commodity derivatives contracts are financial instruments offer sufficient clarity to market participants to understand where the boundaries of the *MiFID* lie?

a) the phrase "...that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event)";

b) the phrase "traded on a regulated market and/or MTF"

c) the definition of a spot contract in Article 38(2) of the *MiFID* implementing regulation:

d) the criteria in articles 38(1)(a),(b), and (c);

e) the definition of a commodity in Article 2 of the *MiFID* implementing regulation; and

f) the list of underlyings of exotic derivatives mentioned in Section C(10) of Annex I to the *MiFID* and Article 39 of the *MiFID* implementing regulation.

The CDWG does not feel that the specific criteria identified lead to difficulties in identifying where the boundaries of MIFID are.

22) Do you have any evidence of physically-settled commodity OTC contracts being written in a way that removes them from the definition of financial instruments?

MIFID does not capture physical forward commodity OTC contracts for the very good reason that they are not 'financial' trades. There are good reasons for engaging in physically-settled OTC commodity derivative contracts which have nothing to do with their falling outside MIFID scope. To suggest that these trades are conducted as so for reasons linked with regulatory 'evasion' misses the point.

The prime reason for physical settlement relates to the commercial necessity of such a contract – it plays a key role in risk management for real economy companies. Players in these markets have a strong economic interest in the physical aspects of the trading as the commodity in question is crucial to the running of their business.

Historically, apart from agricultural products (mostly for historic reasons in the US) most commodities are traded OTC. The key benefit of an OTC contract is the scope to customise the terms of the contract according to the commercial and investment-related specifications of each counterparty (unlike standardised, fungible exchange-traded instruments). That is why electricity, gas, metals, oil, coal, and freight are traditionally traded OTC and without a 'central marketplace.'

Physical OTC energy trading is, in the main, pursuant to industry master agreements such as the EFET and GTMA agreements which govern much EU and UK power and gas trading. These were agreed prior to MIFID and designed to meet market specifics. The CDWG is not aware of such OTC contracts being routinely amended post MIFID, nor of any evidence of such contracts being drafted as described, in order to evade MIFID scope, and is puzzled as to why the CESR/CEBS working group is asking this question.

23) Do you believe there are sufficient similarities between different commodity derivatives markets to make it inappropriate to differentiate the regulatory regime on the basis of the underlying being traded?

While there are differences between different commodity derivatives markets, the CDWG believes that these differences are insignificant next to the wider differences between commodity and financial derivatives markets. The CDWG believes that for bespoke regimes for each individual commodity market to be conceivable, the benefits of such individually tailored regimes would need to exceed the costs of developing such regimes, the costs to the firms of implementing specific regimes for each market or the costs to the regulator of overseeing a range of differentiated regulatory regimes for each commodity market. No evidence has yet been presented to suggest that this would be the case.

24) If the capital treatment of *specialist commodity derivative firms* is resolved, do you think there is still a case for retaining both of the exemptions in Articles 2(1)(i) and (k)? If not, how do you think the exemptions should be modified or eliminated? If the exemptions in Articles 2(1)(i) and (k) were eliminated, what effect do you think this would have on *commodity derivatives markets*?

The prospect of the application of Pillar 1 style capital requirements is a very worrying one for commodity firms. We believe that such a move would come at major cost to the competitiveness of commodity firms engaged in commodity derivatives business in the EU, and indeed to the core commercial business of these firms. We also believe it could come at a major cost to EU markets, and to the ability of the EU to meet its challenges in the commodities sphere (including in the energy sphere). The attractiveness of third country jurisdictions in these circumstances has been commented on elsewhere in this paper, and in earlier submissions by the CDWG.

Nevertheless, we would like to underline that application of a regulatory regime fundamentally unsuitable and inappropriate for the activities of commodity firms is not the only concern that commodity firms have about the MIFID/CRD regime.

The CDWG member firms strongly oppose the inclusion of own account trading by commodity firms with professional counterparties within the scope of a MIFID licensing regime. Neither systemic, nor conduct of business concerns (given the lack of direct retail participation in these markets) justify such regulation.

The CDWG supports replacement of the second limb of both article 2.1(i) and article 2.1(k) with a single exemption for firms (other than operators of MTFs or regulated markets) whose main business consists of dealing on own account in relation to commodities and/or commodity derivatives or other non-financial derivatives contracts. The aforementioned exemption should only apply to the firm's activities when dealing on own account in commodity and other non-financial derivatives with a defined class of '*wholesale market participants*'.

The CDWG strongly believes that this class of *'wholesale market participants'* warrants consideration of a bespoke definition, unrelated to the MIFID definition of professional investors (after all, this relates to the activities of exempted (rather than regulated) commodity firms – and it is difficult to see how an exempted firm (based on the results of the current review) could 'opt-up' clients to new client categories).

Consideration in this regard could include defining *'wholesale market participants'* as including credit institutions, investment firms, any person whose main business is dealing in commodity derivatives and/or commodities, C10 derivatives and/or their underlyings and large undertakings. Consideration should also be given to the inclusion of other participants in commodity markets, such as local authorities, in this definition (otherwise the mere act of dealing with these participants would require establishment of a MIFID firm).

Alternative suggestions, some customising or refering to the MIFID professional definition and existing exemptions, have been made in previous CDWG submissions to CESR/CEBS[1].

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[1] These include:

- That there should be no requirement that 'wholesale market participants'(with whom own account commodity firm dealings would be exempt) undertake ten trades per quarter (as required in the MIFID definition of profesional investors/ECPs) – inappropriate for commodities markets;
- Allowing firms to treat undertakings as 'wholesale market participants' (with whom own account commodity firm dealings would be exempt) where the undertaking is part of a group of undertakings which meets the size thresholds in the MIFID 'professional investor/ECP' definition on a consolidated basis.

The CDWG believes it should be possible to combine the exemption with other exemptions from MIFID.

The CDWG notes the support expressed in paragraph 245 for the principle that the 'exemptions should continue to reflect the original rationale of keeping participants who are trading on own account, and who do not hold themselves out as market makers or dealers, outside the scope of the directive.' The CDWG is concerned at the reference to the condition that exempted commodity firms should not be 'market makers', as it is not clear how this term should apply in commodity derivative markets.

Elimination of exemptions i and k would have negative impact on commodities markets. In particular a large number of small, specialist commodity firms and specialist commodity trading firms would find the new burdens imposed by a MIFID (or a MIFID + CRD) regime very burdensome, and would seriously consider whether or not they could continue their activities. While these firms may not be that large, they play a very important role in not only providing much needed liquidity in commodities markets, they are also key to the EU being able to generate the investment needed to meet its challenges in the commodities area, in particular in the area of energy policy.

Larger commodity firms would be faced with a choice between having to continue operating in Europe under a disproportionate and costly regulatory burden (for those activities that we don't believe should be caught by MIFID scope) or to move to a more competitive jurisdiction.

While some larger commodity firms would continue to trade in European commodity derivatives and commodity markets, albeit subject to a great regulatory burden, we believe that smaller commodity firms would be especially affected, and would not have this choice.

The ultimate impact would be a reduction in liquidity, inefficient price formation, increased volatility, and less scope for real economy firms to manage their business risks through derivative markets.

25) Do you believe based on the above analysis that the application of the *CRD* large exposures regime to specialist *commodity derivative*s firms is disproportionate?

Yes. We believe the large exposures regime which has been designed and recently amended with only financial institutions in mind would be wholly inappropriate if applied to commodities firms.

On the whole commodity firms manage credit risk actively and seek to reduce concentration risk by making use of all available netting and collateralization options. We therefore think that

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- Including companies with securities listed in Europe or under comparable regimes elsewhere (and their subsidiaries) as 'wholesale market participants', regardless of size.
- In relation to commodity and non-financial derivatives, including in the 'wholesale market participant' category undertakings whose main business is trading in commodities or the underlying subject matter of any such instrument or that are producers or professional users of commodities or such underlying subject matter. "

single name large exposures are less likely to be incurred with third parties as part of commodity firms' trading activities.

However, it is important to emphasise that this review has the potential to result in regulation being applied to commodities firms that may create large exposures that do not currently arise in the sector. This is because large exposures can result from operations taken by trading entities on behalf of other group companies. This activity would grow as a result of applying a Pillar 1 minimum regulatory capital charge. Applying a Pillar 1 charge to a subset of the firms' activities will lead to the subsidiarisation of this business. A large exposure can arise between the trading subsidiary and the mother company, for instance if the subsidiary hedges its net market risk with the parent on a going-concern basis. It therefore seems unfair that where a large exposure is created by regulation, our member firms should be penalized for it, as in effect they have little control over the root cause for the risk. We also would like to highlight the fact that some regulators have exempted certain firms from the large exposures regime; in Germany, for instance, power traders are currently outside the scope of LE regulation.

26) Do you agree that the maturity ladder approach is unsuitable for calculating capital requirements for non-storable commodities? If yes, are the proposed alternatives better suited to that task?

The existing version of the maturity ladder approach is definitely not suitable for the calculation of capital requirements for non storable commodities, but we also question whether it is suitable for storable commodities. A market risk charge based on spot prices for all commodity positions would result in capital numbers, particularly for non storable commodities, that do not accurately reflect the risks and would be in practice highly volatile. Furthermore because the maturity ladder buckets are not calibrated for term prices they do not allow firms to accurately net positions which carry a reduced net level of risk over the longer term due to brief fluctuations in daily spot prices.

As we have argued in the past, we do not believe spot prices are a reasonable basis on which to base the maturity ladder for commodities firms. For storable commodities, such as oil or metal, occasional shortages in supply often cause forward price curves to exhibit significant backwardation structures, where prices for short term products are much higher than for products at the long end of the price curve, meaning that spot prices can be less relevant.

Also, the maturity ladder approach requires a 15% charge for the directional risk of all positions. For power and gas the term structure of volatilities (TSOV) is in strong backwardation, and this can lead to a charge deemed too low for short term products such as a week or a month out, and too high for longer term contracts such as Cal09. The 3% charge for basis risk could also be deemed too high for commodities such as metals whose maturity buckets are highly correlated.

The proposed alternative discussed in paragraph 268.2 is inadequate and cumbersome, in our view.

This procedure does not consider correlations within a market risk portfolio, and is not risk-proportionate, leading to a substantial overestimation of charges. In this context, the questionable benefits associated with implementation would not justify the costs of implementation.

27) Do you believe that the shortcomings identified in 2. b. and c. and 3. are relevant? Are there others that need consideration?

We consider this section to be well drafted, and have nothing to add.

28) Do you think that the solutions outlined above are adequate to address these problems?

We consider this section to be well drafted, and have nothing to add.

29) Do you agree with the conclusion in the CESR/CEBS consultation paper of 15 May 2008 on whether there is a case for *a separate class of energy investment firm subject to a regime that differs from the wider commodity regulatory regime*?

The CDWG has not concluded that there are grounds to oppose the conclusion in the CESR/CEBS consultation paper that there is no case for a separate class of energy investment firm subject to a different regime to that applying to the wider commodity regulatory regime.

This statement is without prejudice to the input of the CDWG member associations to the current consultation on the draft CESR/ERGEG advice to the European Commission proposing a bespoke EU Market Abuse framework for electricity and gas markets.

30) Which of the options presented above do you consider appropriate for the application to *specialist commodity derivative firms*?

Our associations propose an alternative approach to the application of the full Capital Requirements Directive (CRD) to specialist commodity firms in the EU. The focus of the alternative approach is on maintaining and demonstrating adequate financial resources, rather than on a minimum regulatory capital requirement. The lack of systemic impact on the financial system, as recognized by CEBS renders a minimum capital charge an inappropriate method of regulating specialist commodity firms.

Regulatory capital also exists for the purpose of protecting customers without the market experience to protect their own interests. Recent market analysis shows that participants in commodity markets consist almost exclusively of a combination of producer/suppliers from the physical market and experienced banks, investment funds, hedge funds and similar, all of whom are presumed to have sufficient market expertise to remove much of the need for additional protection in the form of regulatory capital.

Market participants believe that the imposition of an unmodified CRD will drive many firms to make changes in corporate structure which are at odds with best practice purely in order to comply with CRD requirements. The proposed capital requirements may force smaller firms out of the market and exclude new participants in markets which already suffer from limited liquidity. The continuing existence of lighter touch regimes outside of the EEA provides larger firms with an incentive to relocate their activities to the detriment of EEA Member States.

In order to address these concerns, we propose an approach that removes the need to hold minimum regulatory capital in favour of minimum financial resources, while utilising the flexibility of existing CRD internal review and public disclosure requirements (Pillar 2 and Pillar 3) to reduce risk in commodity markets.

The main features of this Alternative Approach are that:

- the need for computing and holding a minimum level of regulatory capital is replaced in favour of a requirement to ensure an appropriate level of financial resources;
- the approach combines existing and proven risk management practices from a number of EU jurisdictions to create a bespoke regime, rather than simply copying what the banks do; and
- the approach incorporates Pillar 3 and IFRS disclosure requirements and develops requirements which are relevant to the commodity industry.

Under this approach, as a matter of course, a well managed firm must be aware of its own financial resources and measure them against the risk appetite of the business, and this is the fundamental concept underlying Pillar 2 of the CRD. The Alternative Approach applies the same basic principles and requires firms to undertake a comprehensive risk management and capital adequacy review.

What constitutes adequate financial resources will vary from firm to firm as a function of the nature and scale of the business, together with the risk appetite and risk management systems of the firm. We do not therefore propose specific limits on financial resources that would apply to a firm adopting the Alternative Approach. Instead the individual firm must justify the composition and extent of the financial resources that it believes to be adequate, potentially, but not necessarily, with reference to other regulations.

A breakdown of financial resources would form a part of the annual report made by firms adopting the Alternative Approach, much as full CRD firms must assess their level of capital in the ICAAP.

31) Do you think a complementary opt-in or opt-out regime could be helpful?

It is the understanding of the CDWG, following the CEBS public meeting held in London on 7th July that CESR/CEBS may consider advice containing more than one of the four policy options discussed in the paper. That is, that there need not be just one answer, based on the options explored and that any number of the options could be presented as part of a prudential regulatory regime reflecting the diverse nature of firms involved in the review, and the different levels of risks they generate. The idea that a specialist commodity firm could have some flexibility in choosing an appropriate proportional regulatory regime is quite appealing, particularly if full CRD application, in whatever form, remains as an option of the CESR/CEBS final advice.

On the basis that the "full CRD", in particular the Pillar 1 calculations, would be adequately amended to take into account differences between financial and commodity markets, and assuming that the regulatory regime applicable to those firms which chose to opt-out of full application was appropriate for the firms concerned, the CDWG feels that an opt-in or opt-out regime would be a useful way of addressing the differing needs of market participants as regards the interplay between regulatory cost and benefit. It also seems appropriate to make provisions for firms that have already opted to apply a CRD based solution to allow them to continue to use that solution.

The CDWG stresses that while this approach may have merits at a purely conceptual level, full evaluation of such a proposal is only possible once the details of both “full application” and opting-out are known.