TRILAND METALS

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Committee of European Banking Supervisors
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RE: Consultation paper on CESR's/CEBS's technical advice to the European Commission on the review of commodities business ("the Consultation Paper").

Dear Sirs,

Answers to questions posed with relevance to the market in metals derivatives are set out below.

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?**

   As a broker/dealer on the London Metals Exchange ("LME"), Triland Metals Limited's ("Triland") main OTC transactions relate to trading options and averaging. All average deals are OTC. In contrast, option trading is split between customer and counterparty deals, with the former all OTC and the latter cleared by LCH. Clearnet. These both fall within the definition of a 'financial instrument'[1] in the Glossary of the UK Financial Service Authority's ("FSA") Conduct of Business Sourcebook ("COBS"), as adopted from MiFID.

   In contrast to the above, the proportion of spot trades entered into is very small.

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 physical commodity markets), that participation by private clients is very low, and that most other participants in commodity derivatives markets are sophisticated firms?**

   Direct participation by private/retail clients is almost non-existent on the LME. The Consultation Paper suggests large minimum contract sizes as a major reason for limited private participation. However, equally important in deterring private investment is a difficulty in understanding the underlying physical aspects of exchange traded commodities, let alone the financial instruments by which they are exchange traded. Furthermore, some market participants are themselves discouraged from offering services to private clients by

[1] Definitions (e) and (f).

the regulatory burden that this entails. Indeed, whilst some members of the London Metal Exchange may be better equipped to offer services to retail clients by virtue of their affiliation with a larger banking group, for non-aligned brokers/dealers this is a costly prospect.

At present, the level of direct participation in LME activities by unsophisticated investors is overwhelmingly by corporate clients such as miners, smelters and distributors interested in hedging. Their investment knowledge is assessed as a part of the client due diligence/suitability process, and almost all have some experience of exchange trading or, if not, have appointed someone with experience to manage this aspect of their business.

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?**

Brokers/dealers in the metals market undoubtedly have a more intricate knowledge of financial instruments than their clients. However, clients usually have a more than adequate knowledge of the derivatives they are interested in. Furthermore, clients rarely trade beyond their understanding. There is no evidence of a 'knowledge gap' of the sort that preceded the pensions mis-selling of the 1990s involving private clients.

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

The two main forms of informational asymmetries that could lead to abuse in the metals markets have already been stated in the Consultation Paper:

(1) The creation of false impressions of supply and demand to facilitate 'cornering' and 'squeezing' of the market. In July 2007 there were rumours of a concert to squeeze nickel prices on the LME. This prompted the LME to change its lending guidance in respect of nickel positions which was successful in lowering the cash to three months price spread[2].

(2) The potential to manipulate closing prices.

In "*Market Aberrations: the Way Forward*"[3], the LME established robust procedures for identifying and investigating abusive practices which specifically account for the exchange's trading mechanisms. These were praised by the FSA in late 2005: "*The practices have been shown to be an aid in maintaining the integrity of those markets*"[4].

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

No lending is involved in the activities of a LME broker/dealer. Customers are granted credit lines or pay up front in cash, with the risks associated with trading exposures managed by Master Netting Agreements ("MNA") (exchange transactions) and International Swaps and Derivatives Association ("ISDA") Agreements (OTC transactions).

[2] Elstob, P., "LME denies rumours of squeeze on nickel prices", Complinet, 11 June 2007.
[3] LME, October 1998.
[4] FSA Handbook Release 046, September 2005.

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

Specialist broker/dealers with no links to other financial institutions pose limited risk to the financial system because:

(1) They have fewer customers than banks, and these are almost exclusively market professionals.

(2) As most customers are metals producers or distributors, their investment strategies are mainly concerned with hedging the risks of their activities in the physical market. At present, there is little evidence of strategic hedging on the LME involving Ring Dealing Members.

Perhaps the greatest risk that broker/dealers face is reputational. If customers believe that a broker/dealer is in trouble they will simply move their positions over to another firm.

7. **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?**

The level of systemic risk posed by specialist metals broker/dealers naturally differs from that posed by banks and ISD investment firms as the underlying product is different. Unlike liquid deposits or equities, the physical asset underpinning metals derivatives is nearly always deliverable, regardless of the financial situation of the owner. Furthermore, the function of metals brokers/dealers focused on hedging in a narrow range of markets, so the scope cross-market contagion in the event of difficulties is extremely limited.

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

Triland has no transparency-related concerns in relation to the trading of metals based commodities derivatives. Transparency at the LME is very strong due to the following:

(1) The close cooperation of a small community of specialised brokers.

(2) The availability of quality market data published by the LME and a variety of third party sources including Reuters and BaseMetals.com.

(3) Customers usually maintain accounts with two or three LME members, and are therefore able to obtain competitive price information from each of them before placing a trade.

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

The transaction reporting requirements in MiFID are of limited value in regulating trading in metals based derivative contracts for the following reasons:

(1) Where exchange contracts are involved, market integrity is already protected by the necessity to comply with the LME's large position reporting requirements.

(2) The requirement to monitor compliance with the COBS rules relevant to trading, e.g. best execution, is less immediate in the metals markets as the majority of clients are experienced in exchange trading and give specific instructions – rendering the rules inapplicable.

(3) The metals market is less complicated than other financial markets, particularly those involving the trading of equities. Indeed, the LME lacks a primary market equivalent to that of equities exchanges such as the London Stock Exchange ("LSE"). Thus, the risks to market stability associated with stock issues are non-existent on the LME. Hence, whilst recent events have demonstrated that transaction reporting is a useful tool in monitoring the dangers associated with the short selling of equities, trading in metals derivatives is less speculative and is driven by users and or producers of the underlying assets attempting to hedge risks in the physical market.

10. 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 the potential systemic impact?

We, as LME broker/dealers are in agreement with this position for the following reasons:

(1) In our view, regulatory capital primary exists to protect customers without market experience to protect their own interests. As explained above professional customers are well equipped to recognise when something goes wrong and could move their positions accordingly.

(2) Whilst large entities have the resources and expertise to make their own risk model, for smaller firms this prospect is extremely burdensome. The inevitable necessity to consult external expertise will result in a great deal of additional expense, and implementing the model once devised will be very time consuming.

(3) Specialist commodity derivative firms are low risk to the market and the requirements of the CRD are not in proportion to the risk posed by commodity firms. Some requirements of the CRD would be onerous to commodity firms.

11. Do you believe that in 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?

We, as LME broker/dealers are in agreement with this position for the following reasons:

(1) Most trades in the metals market are squared hedges, with the exposure already 'locked in'.

(2) As all metals derivatives trades are 'marked to market' there are few surprises for clients when they seek to close out a position, regardless of whether they have squared their position or not.

(3) The largest exposures of an LME broker/dealer are far smaller than, for instance, large corporate banks that engage in diversified lending or debt security operations.

(4) The metals market has long deployed its own tools, for example MNAs and ISDAs, to reduce exposure.

(5) The customer may provide and we may hold collateral in the form of cash margin or warrants to further reduce exposure.

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

This is not envisaged in the metals market as participant firms have to:

(1) Under LME rules, maintain offices proximate to the City of London (if a Category 1 member).

(2) Be authorised by the FSA which involves satisfying the Threshold Conditions ("COND"), one of which requires that a firm locates its head office in the United Kingdom (all members)[5].

This contrasts to the situation in the energy markets. For example, if a firm wishes to acquire ICE membership it can maintain offices in any location, provided that this is acceptable to ICE Futures Europe[6].

13. Do you believe that the application of the MiFID organisational 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 organisation requirements do you believe do not support the aims of market regulation when applied to such firms and why?

From our perspective, the high level common platform requirements in the Senior Management Arrangements, Systems and Controls ("SYSC", rules 4-10) section of the FSA's Handbook are adaptable to a prudential regime involving qualitative risk management (see below).

14. Do you believe that there is a case for changing the client categorisation regime as it applied to commodities derivatives business? If so, do you have any evidence on the scale of the problem or potential problem posed by existing rules?

There have been no problems in applying the new client categorisation regime so far. However, the expanded definition of professional client and eligible counterparty proposed by the Commodities Futures Working Group ("CFWG") would be a sensible development given the differences between the retail and commodities markets. Added in flexibility in this area would be welcome, particularly with regards to 'opting up' small but knowledgeable clients that do not meet the size criteria in COBS 3.5.

15. Do you believe that the conduct of business rules in the MiFID effectively support the aims of regulation with respect of commodity derivatives 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 derivatives business?

With the exception of selected elements of COBS 2 (Conduct of Business obligations); COBS 3 (Client Categorisation); COBS 4 (Communicating with Clients); COBS 9 (Suitability); COBS 11 (Dealing and

[5] COND 2.2, FSA Handbook.
[6] Participant Membership Criteria, ICE Futures Europe (https://www.theice.com/member_criteria.jhtml) (last viewed 30/07/2008).

Managing); and COBS 16 (Reporting Information to Clients); most conduct of business rules in MiFID are not applicable to a broker/dealer in the metals markets. This is mainly owing to a professional client base and the types of investment products/services offered.

Perhaps the most problematic conduct of business requirement for an LME broker/dealer is the necessity to obtain the prior express consent of professional customers to its best execution policy before proceeding to execute their orders outside a regulated market or MTF (COBS 11.2.26). Naturally, this applies to OTC options and average price trades. Owing to differences in culture, it can be extremely difficult for broker/dealers to obtain the required consents prior to trading from clients based in third countries outside the EEA.

In addition to the above, best execution itself is of limited regulatory value when applied to the activities of an LME broker/dealer. As previously mentioned, most transactions follow a specific instruction from the client. Furthermore, a client typically obtains quotes from a number of different brokers before giving market orders in order to compare prices, speed and likelihood of execution. Accordingly, at the LME where the numbers of active customers are limited, an informal regulation of execution exists where clients simply switch between their brokers in order to obtain the best possible result for their transactions. This differs from the position in the retail environment where an individual usually only has a relationship with one broker (particularly for small transactions) and relies solely upon their judgement when entering into transactions. Therefore, there is a strong argument that the application of best execution requirements to specialist commodities firms greatly increases their compliance costs with little regulatory benefit.

16. Which of the options for an appropriate prudential regime do you consider appropriate for the application to specialist commodity derivative firms?

We consider that Options 1 and Option 2 are more appropriate. Due to the relatively low risk posed by a specialist commodity firm, it would be unreasonable to set a prudential regime which is designed for higher risk entities and which would put commodity firms at a disadvantage to compete in the market place. Ultimately those users and producers of metals who use specialist commodity firms to hedge the risk in their buys and sells may lose avenues currently available to them.

Yours faithfully

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