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15 May 2008

Consultation paper on CESR's/CEBS' technical advice to the European Commission

on the review of *commodities business*

Introduction

1. On 21 December 2007, the European Commission issued a Joint Call for Advice asking CESR and CEBS for further technical advice on the regulatory treatment of firms that provide investment services relating to commodity derivatives and exotic derivatives. The advice will assist the Commission services in carrying out their review under Article 65(3)(a), (b), and (d) of Directive 2004/39/EC on Markets in Financial Instruments (*MiFID*) and Article 48(2) of Directive 2006/49/EC on Capital Adequacy (*CAD*).

2. This Joint Call for Advice builds on previous technical advice provided by CESR and CEBS in 2006 and 2007[1]. In it, the Commission requested:

    a) an analysis of market failures arising from the present regulatory and market situation;

    b) an analysis of regulatory failures arising from differences in the regulatory treatment across categories of firms that provide investment services relating to *commodity derivative*s, or across Member States;

    c) whether it can be anticipated that any failures identified under a) and b) would be eliminated as a natural consequence of market evolution in the short to medium term;

    d) whether the *MiFID* and *CAD* treatment of firms providing investment services relating to *commodity derivative*s continue to support the intended aims of market and prudential regulation;

    e) whether the analysis under d) varies significantly depending on the type of entity providing the investment services or the underlying of the financial instrument; and

[1] The reports are published at http://www.c-ebs.org/press/documents/CO_%20Supervisory%20survey.pdf, http://www.c-ebs.org/Advice/documents/Commoditiesriskassessment10102007.pdf, http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=4821 and http://www.cesr.eu/index.php?docid=4821.

f) CESR's and CEBS's views on various options and combinations of options relating to the exemptions set out in the *MiFID* and the *CAD*.

CESR and CEBS were asked to analyse the options identified in an initial screening, for further study in terms of likely impacts (costs and benefits) on market quality and on market users, including intermediaries and consumers/suppliers of commodities.

3. In the context of its previous advice, CESR conducted a survey on the transposition of Articles 2(1)(i) and (k) of the *MiFID* and Article 38 of the *MiFID* Implementing Regulation and the practical application of these provisions by European securities regulators.

4. CEBS conducted a survey of current prudential supervisory practices for the commodities business and for firms carrying out commodities business, as well as an assessment of the prudential risks arising from *commodity markets* and from the activities of firms carrying out commodities business. The final section of CEBS's previous advice contained an initial analysis of the implications of regulatory changes.

Methodology and objectives

5. CESR and CEBS created a Joint Task Force on Commodities (ComTF) to prepare their response to the Joint Call for Advice. The findings and recommendations of this consultation paper build mainly on the technical advice already provided to the Commission by CESR and CEBS.

6. The findings and recommendations also take into account the results of the Call for Evidence issued by the Commission on 8 December 2006 and a December 2007 UK discussion paper on the Commission's review of the financial regulatory framework for commodity derivatives.

7. In order to obtain stakeholders' initial reactions to the issues addressed in the Call for Advice, CESR and CEBS published their own Call for Evidence on 18 January 2008. CESR and CEBS received six responses. Two respondents requested confidential treatment of their responses. The other responses[2] have been published on the CESR website under http://www.cesr.eu/index.php?page=responses&id=107.

8. The screening impact assessment was conducted with the assistance of CESR Econet and followed, to the extent possible, the 3L3 framework for impact analysis.

9. The main findings and conclusions of this paper were discussed with industry experts prior to public consultation, in a workshop held on 15 April 2008.

10. This paper is now being published for consultation. The consultation period will run until 1 August 2008. Responses received will be published on the CESR and CEBS websites, unless the respondent requests otherwise. Following analysis of the responses received, CESR and CEBS will deliver their final advice to the European Commission during autumn 2008.

11. The purpose of this public consultation is to gather industry feedback on the conclusions drawn from the market and regulatory failure analyses, to gather

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[2] ISDA/FOA/EFET, German Banking Association, Danish Shareholders Association, BDEW

feedback on the likely impact of the options for a possible future prudential regime for commodity derivatives markets, and to obtain input on specific issues. For this last purpose, specific questions have been inserted throughout the consultation paper.

Executive summary

12. Part A of this consultation paper describes EU commodity derivatives markets in terms of products, trading venues, and participants. This section is intended to provide context for the sections that follow. Key findings include:

    - the largest market in commodity derivatives is in oil derivatives;
    - trading in commodity derivatives on regulated markets is growing strongly, but most trading of commodity derivatives in the EU still takes place outside regulated markets;
    - producers and distributors of commodities seeking to optimise the prices of their products historically have constituted the most active force in commodity derivatives markets, but in recent years there has been an increase in the number of private and institutional investors entering these markets in the pursuit of financial returns;
    - this increasing involvement of private and institutional investors is expected to be a long-term trend.

13. Part B examines potential market failures in commodity derivatives markets, to provide a framework for the subsequent discussion of policy options. It focuses on market failures linked to asymmetric information and negative externalities. Key points include:

    - low levels of transparency in *OTC* commodity derivatives markets are a source of concern. Market participants (both investment firms and their clients) are invited to comment on whether low transparency deters participation in these markets;
    - commodity derivatives markets, like other financial markets, are subject to informational asymmetries which can lead to abusive market conduct;
    - the activities of *specialist commodity derivative firms* can give rise to systemic risks through externalities, but the systemic risks generated by these firms generally appear to be low compared to the systemic risks and externalities generated by banks and *Investment Services Directive* (*ISD*) investment firms;
    - energy-only investment firms do not appear to be associated with externalities and systemic risks that are materially different from those associated with other *specialist commodity derivative firms*.

14. Part C discusses potential regulatory failures related to firms that provide investment services in commodity derivatives markets, and considers whether potential regulatory failures lead to competitive distortions. This section begins with a brief description of the differences in the regulatory treatment of firms and activities in the commodity derivatives market. It then analyzes potential regulatory failures and assesses their relevance. Regulatory failures may arise from regulation that is not sufficiently adapted to the specificities of the commodity derivatives market, or from differences in regulatory treatment across the EEA.

15. Part C also discusses whether the free movement of services between Member States may be distorted and whether there is evidence of regulatory arbitrage.

16. Part D of the consultation paper deals with two main issues. First, the paper explores whether *MiFID* rules (relating to pre-trade and post-trade transparency, organisational requirements, conduct of business rules, client categorisation, etc.) should be adapted for commodity derivatives business.

17. Second, it discusses where the boundaries of the *MiFID* should be set with respect to commodity derivative contracts and firms providing investment services/activities relating to commodity derivatives.

18. Regarding *MiFID* rules, the industry has raised concerns about how the client categorisation rules apply to commodity derivatives business. The consultation paper asks for further details on the perceived problems.

19. Regarding the boundaries of regulation, the consultation paper suggests that the definition of commodity derivatives generally works well, but asks for evidence as to whether the criteria for the inclusion of *OTC* commodity derivative contracts as financial instruments are too narrow. It also suggests that there is a case for revising rather than eliminating the exemptions in Articles 2(1)(i) and (k) of the *MiFID*.

20. Part E of the consultation paper deals with the Commission's questions relating to the treatment of specialist commodity derivative firms in the CRD. A number of issues that have already been mentioned in the *second part of CEBS's technical advice* to the Commission are discussed separately.

21. First, the paper discusses the application of the CRD's large exposures regime to specialist commodity derivative firms, which are currently exempted from that regime in accordance with Article 45 of the CAD. It concludes that the full application of the large exposures regime 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 excessive.

22. Second, the paper discusses the maturity ladder approach and why it appears to be unsuitable for certain commodities – in particular, non-storable commodities. The paper suggests two alternative approaches, one using the current forward price, and the other deriving forward prices based on a history of forward prices over a specified observation period.

23. Finally, the paper examines several options for regulating *specialist commodity derivative firms*. (It should be noted that there unavoidably a disparity between these two parts, as the large exposure regime could well be a part of a comprehensive new regulatory regime.) One option would be not to require regulatory capital under Pillar 1, but instead to rely on qualitative risk management requirements. This approach was favoured by some industry respondents. As a second option, these qualitative risk management requirements could be complemented with Pillar 2 capital requirements. A third option would be to recalibrate the CRD to better fit *specialist commodity derivative firms*, including recalibration of Pillar 1 capital charges. A fourth option would be full application of the CRD with a tailored exemption regime for certain firms. This section of the paper concludes with a discussion of the possibility of allowing firms to opt in or out of regulation, in effect choosing

between the preferential treatment of the 'institutions' exposure class in the CRD (if they opt in) and less burdensome regulation (if they opt out).

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Glossary

Expressions from the Glossary are written in *italics*
in the main document

CAD	Capital Adequacy Directive (Directive 2006/49/EC)
Cash market	Within each market for a type of underlying, the *cash market* is limited to spot contracts in the sense of Article 38(2)(a) of Commission Regulation 1287/2006
CCR	Counterparty credit risk is the risk that a counterparty to a transaction will default before the final fulfilment of its obligations with respect to the transaction. This definition covers default by a counterparty before both the transaction's cash flows and the contracted deliveries are settled, and as such includes both *CCR* in the narrow sense as defined in Annex III, Part 1, point 1 of Directive 2006/48/EC, and settlement/delivery risk and free deliveries as treated in Annex II points 1 to 4 of the *CAD*)
Commodity derivatives markets	Markets for *commodity derivative*s (if the market for a specific product is meant, then the product is mentioned)
Commodity	Any goods of a fungible nature that can be delivered, including metals and their ores and alloys, agricultural products, and *energy* such as electricity (according to Article 2 paragraph 1 of the Commission Regulation 1287/2006 (*MiFID* Implementing Regulation))
Commodity market(s)	Markets for physical commodities and *commodity derivative*s (if the market for a specific product is meant, then the product is mentioned)
Commodity derivative	Financial instruments listed in Annex I, Section C(5) to (7) of the *MiFID.* Unless otherwise indicated, any reference to *commodity derivative* in this document also includes 'exotic' derivatives.
CRD	The Capital Requirements Directive (Directive 2006/48/EC and Directive 2006/49/EC)
Energy	Oil, gas, coal, electricity, and biofuel
Exotic derivative	Financial instruments listed in Annex I, Section C(10) of the *MiFID* (derivatives with climate variables, freight rates, emission allowances or inflation rates, or other official economic statistics as the underlying)
Forward transaction	A contract that includes an obligation of at least one of the counterparties that has a due date which is later than for

	spot contracts in the sense of Article 38(2)(a) of the Commission Regulation 1287/2006
Futures	Standardised forward transactions that are traded on an exchange
Institutions	Credit institutions and investment firms as defined in the *CRD* and the *MiFID*
ISD	The Investment Services Directive (Directive 93/22/EEC)
MiFID	Markets in Financial Instruments Directive (2004/39/EC)
MiFID Implementing Regulation	Commission Regulation (EC) 1287/2006 of 10 August 2006
MTF	A Multilateral Trading Facility as defined in Art. 4 (15) of the *MiFID*
OTC	Over the counter (i.e. any transaction conducted outside a regulated market or *MTF*)
Physical position	A transaction settled in physical form (i.e. by delivering the underlying)
Second part of CEBS's technical advice	The CEBS commodities prudential risk report published at http://www.c-ebs.org/Advice/documents/Commoditiesriskassessment10102007.pdf
"Sophisticated" client/market participants	Clients/market participants that possess the experience, knowledge, and expertise to make their own investment decisions and properly assess the risks they incur. Note that the market/regulatory failure analysis does not comment on minimum standards/criteria (e.g. size) that both sophisticated and unsophisticated participants would be expected to satisfy.
Specialist commodity derivative firm(s)	Firms that restrict their *MiFID* activities/services to commodity and exotic derivative financial instruments (i.e. that do not engage in wider investment activity, for example in stocks and bonds) and are not part of a group the main business of which is the provision of other investment services within the meaning of Directive 2004/39/EC or banking services under Directive 2000/12/EC. (These firms tend to be active in the underlying product market.)

Part A. EU *COMMODITY DERIVATIVES MARKETS*

24. As background to the analysis of potential market failures in Part B of this consultation paper, this Part provides an overview of the relevant EU commodity derivatives markets in terms of products, trading venues, participants, and the rate of investor participation. The material in this section is generally intended to supplement the market description provided in the responses to the Commission's previous calls for advice/evidence on commodities business.

25. Differences in definition should be noted. Part B draws on a variety of sources to indicate the size and composition of commodity derivatives markets. However, references to commodity 'derivatives' in these sources do not necessarily match the *MiFID* definition of financial instruments[3]. For example, some physically settled forward contracts which are not *MiFID* financial instruments are often reported as commodity derivatives in statistical data. In addition, some of the sources include information on *MTF* trades in *OTC* market descriptive data; in contrast the definition of *OTC* used in this consultation paper excludes *MTF*s.

26. Data sources for commodity derivatives markets frequently provide information on notional outstanding amounts, and some of this information is included in this paper. However, care should be exercised when using these figures as a measure of the riskiness of the positions. A better (but less frequently reported) measure of risk is the gross market value of outstanding contracts, which represents the cost of replacing open contracts at prevailing market prices.

I. Products

27. The largest markets in the commodity sector are in oil derivatives, for which the notional value of contracts cleared through a clearing house in the United Kingdom alone is $5 trillion per annum[4]; and gas derivatives, for which the total EU market has reached €400 billion[5] yearly turnover. Electricity markets are also significant; between 60-80% of business in electricity markets is conducted *OTC* or via *MTF*s[6]. Only the United Kingdom has a dedicated metals exchange – the London Metal Exchange (LME) – which in 2007 had an annual turnover in excess of $9.5 trillion and traded 95.9 million contracts, all of which were cleared[7]. Soft commodity derivatives are dominated by *OTC* trading, although there are some exchanges (see below). The volume of soft commodities contracts traded on Euronext-Liffe rose 30% in 2007 to 12.8m

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[3] I.e. to the financial instruments listed in Annex I, Section C (5) to (7) and (10) of MiFID.
[4] Annex III of the second part of CEBS Technical Advice
[5] Ibid.
[6] Ibid.
[7] Ibid

contracts, and volume was at 1.4m contracts in January 2008 (up 75% on Jan 2007)[8]. According to recent BIS data[9], the rate of increase in global turnover of agricultural derivatives was greater than for other commodities, rising from 257 million contracts in March 2007 to 296 million contracts in March 2008. Other exotic derivatives markets include freight; the notional value of trading in Forward Freight Agreements in the *OTC* and *MTF* derivatives markets is around $30 billion[10]. Liquidity in climate contracts is thought to be relatively thin in the EU relative to the United States. The EU Emissions Trading Scheme was worth only about €35 million in 2006[11], but this represents a 150% increase over the previous year, and emissions allowances are now traded in the United Kingdom, Germany, France, and Norway. Daily volumes of trades in ECX derivatives contracts grew 190% between January 2007 and January 2008 to reach 7.6 million tonnes. Telecommunications bandwidth trading is also growing. It is estimated that the volume of electricity traded on French wholesale markets reached approximately 550 trillion watt-hours in 2007, including both spot and derivative transactions. Current estimates of the market share of Powernext vary between 40% and 50% for spot contracts (day-ahead and intraday), and between 20% and 25% for forward/future contracts, the remainder being *OTC* transactions. In 2007, Powernext day-ahead contracts represented 44 trillion watt-hours and Powernext futures contracts represented 79 trillion watt-hours, while 4 trillion watt-hours of bilateral *OTC* derivative transactions were cleared through Powernext.

28. Some of these markets, such as crude oil and liquified natural gas, are global; others, such as electricity, are regional; and some, such as the market in plastic derivatives, are still highly fragmented. One useful measure of the relative size of a derivatives market is the ratio of derivative transactions to physical production. For gold, copper and aluminium, the volume of exchange-traded derivatives was around 30 times larger than physical production in 2005[12].

II. Trading venues

1. *OTC*

29. EU *commodity derivatives markets* are dominated by trading outside regulated markets: i.e. by trading via *MTF*s and *OTC*. This is a reflection of the dominance of *OTC commodity derivatives markets* on a global level: the notional value of outstanding *OTC* commodity contracts worldwide has grown 6-fold since 2004 to over $8 trillion as of the end of June 2007. The gross market value of these contracts is estimated at $690 billion[13].

30. *OTC* agreements represent an estimated 85 per cent of the notional value of outstanding *commodity derivative*s in the United Kingdom[14]. London is a

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[8] Commodities Now (April 18 2008)
[9] BIS Quarterly Review March 2008
[10] IFSL March 2006
[11] FSA Emissions Paper: http://www.fsa.gov.uk/pubs/other/emissions_trading.pdf
[12] International Financial Services Limited (2006): Commodities Trading
[13] Bank for International Settlements (Triennial and semi-annual surveys on positions in global *OTC* derivatives markets) November 2007.
[14] Note that this *OTC* percentage does not include significant amounts of trading as it does not include contracts that have been closed out and non-*OTC* traded contracts

major centre for *OTC* trading of *commodity derivative*s, with an estimated 14% global market share, and is by far the largest global centre for non-exchange-traded contracts in precious metals.[15]

31. In the Netherlands, 90% of *energy* trading is *OTC* and the volume of *OTC* trading in electricity contracts is 10 times larger than the volume of exchange-traded contracts[16]. In Norway, the volume of *OTC* trading in electricity contracts is roughly twice the size of the exchange-traded market[17]. The vast majority of the gas market is *OTC,* with the United Kingdom and Netherlands having the most liquid markets[18]. There is an *OTC* freight rate market in Norway[19]

32. Most *OTC* contracts are governed by standardised master agreements. BIS data[20] indicate that roughly half of the notional value of total outstanding contracts in global commodities markets (excluding precious metals) is in forwards and swaps, and half in options. Unfortunately the BIS does not further disaggregate the data to distinguish between forwards and swaps, nor does it provide disaggregated data comparing forwards and swaps with options by type of commodity. However, industry sources indicate that the most common *OTC commodity derivative* transactions are forward purchases and sales which can be physically settled to meet consumer needs, swaps which are cash-settled, and options (caps and floors) which although usually cash-settled provide for physical settlement as an option. This suggests that a significant proportion of the *OTC* derivatives reported by the BIS would fall within the scope of the *MiFID*, since most swaps and options, as well as a portion of forwards, are cash settled (making them C5 *MiFID* instruments). Moreover, a significant portion of forwards are transacted through *MTF*s, which qualifies them as derivatives in the sense of the *MiFID*.

33. There is some uncertainty regarding the proportion or amount of *OTC* commodity transactions that are 'spot' in practice (and thus outside the *MiFID*).

Question (Please provide details/evidence in support of all answers)

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)

2. Trading on regulated markets

[15] IFSL July 2006
[16] Pg 14 Annex III of the second part of CEBS Technical Advice
[17] pg 14 Annex III of the second part of CEBS Technical Advice
[18] Pg 16 ibid
[19] Pg 19 ibid
[20] http://www.bis.org/statistics/derstats.htm

34. Exchange trading of *commodity derivatives* more than doubled between 2001 and 2005, reaching around 878 million contracts[21]. However, this represents less than 10% of total global *futures* and options traded on exchanges[22]. Exchanges in different EU member states are at different stages of development, with some pan-European and others purely national[23].

35. The majority of exchange trading in the EU is conducted in the United Kingdom (roughly 15% of global commodity trading)[24]. There are three major London-based derivatives exchanges: the LME, ICE Futures Europe, and LIFFE. ICE Futures Europe saw record volumes of 138 million contracts in 2007[25]. For the full year 2007, volumes of 'soft' commodities transacted in LIFFE are estimated at:

   - Cocoa: 3,319,396 *futures* contracts, notional value €48.7 billion
   - Robusta coffee: 4,435,793 *futures* contracts, notional value € 28,2 billion
   - White sugar 2,091,654 *futures* contracts, notional value € 23,3 billion

36. There are two major exchanges in Germany that provide services relating to *commodity derivatives*: the EEX (electricity, coal, natural gas, emissions) and the RMX (agricultural commodities). The total volume traded or cleared through the EEX is equal to approximately 20% of the total electricity consumed in Germany[26]. The majority (80%) of volume on the EEX is in the form of cleared *OTC* contracts, which automatically fulfil the *MiFID* definition of financial instruments. In addition, EUREX provides services relating to trading in emission allowances.

37. France has an exchange dedicated to soft commodities (MATIF) which offers commodity derivatives, mainly in milling wheat, corn, and rapeseed oil. All of its trades are cleared by LCH-Clearnet S.A.; roughly 80% of these trades are brokered. An estimated 980,742 milling wheat *futures* contracts with a notional value of €10.1 billion were traded on MATIF in 2007. The figures for rapeseed for the same period are estimated at 438,849 *futures* contracts with a notional value of €7.1 billion.

38. In the Netherlands, the majority of exchange trading in *commodity derivatives* is conducted on the European Energy Derivatives Exchange (ENDEX), which is a regulated market trading gas and electricity derivatives. Trading volume on ENDEX accounts for 5 to 10% of total Dutch trading volumes in electricity and gas, and is roughly equal to total annual Dutch *energy* consumption.

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[21] IFSL July 2006
[22] Futures Industry Magazine (March/April 2007)
[23] Eurelectric Response to Commission's Call for Evidence (page 5)
[24] IFSL July 2006
[25] ICE Futures Europe.
[26] The figures for the German electricity are derived from volumes published by EEX and statistics on primary *energy* consumption published by German Federal Statistical Office (Destatis). Total trade volume (including cleared *OTC* trades) for electricity on EEX in 2007: 1,273 TWh; this includes 123.7 TWh on the Spot Market and 1,150 TWh on the Derivatives Market (cf. http://www.eex.com/en/Press%20Room/Press%20Release/press/28465). Of the total volume on the EEX Derivatives Market, approximately 20% of trades were originally conducted on the EEX and 80% were *OTC* trades cleared via EEX/ECC (this approximation is derived from the trading volume in electricity derivatives in December 2007: it totalled 49.1 TWh, which includes 39.9 TWh from *OTC* clearing; cf. http://www.eex.com/en/Press%20Room/Press%20Release/press/28139). Total primary *energy* consumption e.g. in 2005: 14.213 Petajoule = 3.948 TWh (cf. page 12 of Statistical Yearbook 2007 for the Federal Republic of Germany, http://www.destatis.de/jetspeed/portal/cms/Sites/destatis/SharedContent/Oeffentlich/AI/IC/Publikationen/Jahrbuch/Statistisches_20Jahrbuch2007, property= file.pdf; note that 1 Terawatthour = 3600 Terajoule; 1 Petajoule = 1000 Terajoule.)

39. In Norway, there is a distinction between a regulated market and a regulated market which also is an exchange. Nord Pool is Norway's only *commodity derivative*s exchange; nearly half of the contracts in the Nordic electricity derivatives market are traded on it. Other regulated markets in Norway include the International Maritime Exchange - Imarex (freight derivatives), Fish Pool (Salmon derivatives) and FishEx (Salmon derivatives). It should be noted that nearly all exchange-traded contracts in Norway are cleared; and almost all of the contracts in the electricity derivatives market, with the Nordic electricity market as the underlying product, are cleared. There are two clearinghouses in Norway for *commodity derivative*s, both of which clear *commodity derivative*s contracts with cash settlement.

40. In Italy, derivatives are traded on two exchanges: the Securitised Derivatives Market (SeDex) and the Italian Power Exchange (IPEX). There is one exchange in Spain, the MFAO Olive Oil derivative market; and one in Portugal, the OMIP Electricity Market exchange.

41. Commodities are also traded on other exchanges, including the Vienna Stock Exchange (Wiener Börse) in Austria, the Belgian Power Exchange (BELPEX), the Budapest Stock Exchange (BSE) in Hungary, the Warsaw Commodities Exchange in Poland, the Sofia Commodity Exchange in Bulgaria, the Romanian Commodities Exchange, and exchanges in Finland, the Baltic States, and Greece. In the Czech Republic, the most traded *commodity derivative* category is *futures*.

3. Multilateral Trading Facilities

42. Multilateral Trading Facilities (*MTF*s) have also gained in importance in several financial markets around the world, as an alternative to traditional exchanges or as a complement to voice broking and bilateral *OTC* trading.

43. The United Kingdom is home to several *commodity derivative MTF*s, including Spectron, ICAP (which has a global presence), GFI, Prebon, TFS, and Global Coal. ICAP, Spectron, and Prebon are also active in the German markets along with Amerex Energy LLP, Amstel Securities N.V., GFI Security Ltd, IMAREX ENERGY AS, and Tradition Financial Services GmbH. In France, Powernext S.A. trades contracts in electricity and gas[27] and Bluenext trades carbon emission allowances and credits; both entities are regulated as *MTFs*.

III. Participants

44. Producers and distributors have traditionally constituted the most active force in the market, using *commodity derivative*s to optimise the prices of their products. This price optimisation includes both trading on their *physical position*s and proprietary trading which is difficult to distinguish in a portfolio.

45. The commodity trading function of some of these commercial participants has evolved: they have started to provide investment services or activities relating to commodities and *commodity derivative*s other than dealing on their own account. This development has given rise to the *specialist commodity derivative firm*. Approximately 60% of financially regulated UK firms that participate in the *commodity derivatives market* are such specialists.

[27] Ibid.

Similarly, in Germany, where a *MiFID*-like regime has been available for commodity firms for several years, there are a limited number of licensed firms specialising in the *energy* sector. The German Federal Financial Supervisory Authority (BaFin) supervises two medium-sized *energy* traders and seven subsidiaries of *energy* traders (including some of the largest market participants), which are legally separate subsidiaries designed to provide investment services (portfolio management, dealing on own account, reception and transmission of orders, investment advice) to other *energy* market participants. These *specialist commodity derivative firms* typically form part of a wider commercial group, the balance sheets of which contain substantial fixed assets such as tradable commodities (e.g. oil, metals and agricultural produce) and/or commodity-producing assets (such as power stations, oil rigs).

46. There has been a marked change in recent years, as more private and institutional investors have sought financial returns through investment and proprietary trading in commodities. For example, the number of hedge funds trading in *energy* markets has tripled to more than 500 since 2005[28]. Another example is the prevalence of 'Managed Money Traders' or MMTs, which now dominate non-commercial trading in gas and oil.[29] The aggregate share of non-commercial traders has increased from 17% in the late 1990's to 25% in the past three years.[30] Financial investors also play an increasingly important role in *OTC* markets. Hedge funds, locals, and proprietary trading houses accounted for almost one third of trading commissions paid on *OTC* transactions cleared through ICE in 2005, compared to less than 5% in 2003.[31] Pension funds and insurance companies are also large new investors in commodities.

47. As highlighted in the *second part of CEBS's technical advice*, credit institutions and investment firms are active in the *commodity markets* in the following ways:

    a) Lending (including provision of collateral and guarantees). One of the main activities of credit institutions is to provide money to other market participants, including market participants in the commodities sector. However, lending to this sector is normally only a small part of the overall lending business of most credit institutions. Lending specifically related to commodities includes:

        i. 'normal' business financing of commodities firms or distributors;

        ii. specialised lending, e.g. financing of power plants, mines etc. (risks: credit risk, but related to the specific commodity sector); and

        iii. lending to hedge funds with significant commodity-related investments.

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[28] BIS Quarterly Review, March 2007
[29] Ibid
[30] Ibid
[31] Ibid quoting ICE 2006

b) Structured products. Here the institution is selling expert know-how in financial products, creating fee income without necessarily running market or counterparty risks.

c) Providing trading services for clients.

d) Trading. Credit institutions and investment firms carry out different types of trading activities:

   i. proprietary trading (including investments in hedge funds), i.e. speculation on market prices or market price parameters. Trading intent is based on a speculative view of the future and the firm is exposed to market risk and counterparty risk.

   ii. arbitrage. Here the trading intent is to take advantage of price differences between different markets/products/maturities/etc. As result, the firm is exposed to counterparty and market risks.

48. The participation of *institutions* in *commodity markets* has increased in recent years, especially since the liberalisation of the *energy* markets. Some institutions act as market makers or are even involved in the physical business. However, it is not possible to distinguish the market of commodity related financial instruments or *exotic derivative*s from the underlying physical market in terms of market prices, participants, and competitive environment.

49. In the Netherlands, the most active players in the *commodity derivatives market* are the large *energy* producers, followed by large industrial consumers. In recent years, banks, investment firms, and institutional investors have entered this market. Trading Members of ENDEX include producers, large *energy* consumers, specialist commodity traders, and financial institutions. In non-*energy commodity derivatives market*s, the players are mainly large industrial or specialist trading companies.

50. In the Czech Republic, *futures* are the most heavily traded *commodity derivative* contract, and only one investment firm is strongly commodities-oriented. In Holland, trading in agricultural derivatives has shifted to other countries such as France and Germany.

51. Not all commodity producers, distributors, and users participating in *commodity derivatives markets* are necessarily *sophisticated* market participants[32]. For example, a significant amount of business in *energy* derivatives markets in some countries is done on behalf of undertakings, such as municipalities, that are unsophisticated clients.

52. There is very little evidence of direct investment by unsophisticated private clients in the *commodity derivatives market*. A recent FSA survey reported "the unanimous view is that there is hardly any retail investment"[33].

53. The *second part of CEBS's technical advice* found that, "based on market information and industry responses, in most *commodity markets* there is very little direct private client participation or instances of smaller, less-sophisticated customers acting as direct counterparties to the main market

[32] These investors might have long-term experience with particular commodities but lack experience and knowledge with respect to derivatives on these commodities.

[33] FSA Occasional paper, Growth in commodity investment: risks and challenges for commodity market participants, March 2007

participants. Only one respondent to the industry questionnaire said that it deals with retail clients in the base metals market, while two indicated that they deal with retail clients in the precious metals market. *Institutions* responding to the survey on commodities activities reported that they do not deal with retail clients. Indirect retail involvement through *institutions*, on the other hand, may be growing…". Dutch private client involvement is limited to indirect participation via certain structured products offered by larger banks.

54. The low levels of participation on the part of unsophisticated private clients is explained in part by the large minimum contract sizes. For example, until recently the smallest tradable contract of copper on the LME was worth approximately USD 170,000. Consequently, only very wealthy investors have had sufficient assets to manage a portfolio of *commodity derivative* instruments. However, the market is becoming more accessible to unsophisticated investors, who can limit their risk and reduce transaction costs by investing in professionally managed *commodity derivative* funds. For example, in recent years, products such as Exchange Traded Funds (ETF), Exchange Traded Notes (ETN), Exchange Traded Commodities (ETC), covered warrants, contracts for differences, and structured notes have been developed for commodities.

55. Unsophisticated private clients are exposed to commodities indirectly through pension funds. While UK pension funds have been slow to invest in *commodity derivatives*, it is a popular form of investment in the United States and with some large funds in the Netherlands. For example, the Dutch Civil Service pension fund (ABP), with fund assets of over €200 billion, has 3 per cent of its total assets under management invested in commodities,[34] and the 'Zorg en Welzijn' pension fund reported investments of €4.8 billion (5.5 per cent of invested assets) in commodities at the end of the fourth quarter of 2007.[35]

56. Total EU pension fund investments reached an estimated €2,445 billion in 2005.[36] Figures are not available as to how much of this was invested in the commodities sector, but assuming the figure to be 1.5% (the percentage of all G10 *OTC* derivatives contracts that are commodity derivatives contracts, in terms of notional amount), that would amount to approximately €36 billion (or 1.8% of EU GDP).

IV. Investor participation

57. Since 2000, the level of investment in commodities has risen significantly. Commodity-related assets are now regarded as an investment class in its own right. Investors are particularly interested in commodities as opposed to traditional financial assets for two main reasons:

a) Portfolio diversification. The prices of commodity-related assets historically have been negatively correlated with the prices of other assets and thus provide opportunities for portfolio diversification.

b) Inflationary hedge. Commodity-related assets provide investors with a new type of hedge—in addition to traditional hedges such as real property or equities—in the current inflationary environment.

[34] http://www.abp.nl/abp/abp/investments/investments/investments/tabel_investment_strategy_mix.asp
[35] http://www.pfzw.nl/Images/08-2180%20Kwartaalbericht%20Q4%202007NL-4_tcm20-127977.pdf
[36] EUROSTAT estimates

58. The increase in investor participation has been facilitated by increased access to *commodity markets* through the development of commodities *futures* markets, an increase in number and size of electronic commodity trading platforms, and an increase in the number of commodity investment indexes available. The consensus of opinion is that these factors will persist, and that the influx of investors into *commodity markets* is a long-term trend.

Part B. Market failure analysis[37]

Commission Questions

1) Does the present regulatory and market situation for firms providing investment services relating to commodity derivatives and exotic derivatives give rise to market failure in the relevant markets, in particular by:

i) Hampering the aims of market regulation, e.g. ensuring investor protection and market integrity via principles and rules relating to organisational requirements and conduct of business of firms, or designed to ensure fair and orderly trading with optimal levels of transparency, or

ii) Hampering the aims of prudential regulation, e.g. stability of the financial system and provision of sufficient protection for depositors? "

59. Market failure is defined in the Call for Advice as "any significant sub-optimality in market functioning". We have focussed on what we consider to be the main areas of potential market failure in the area of *commodity derivatives markets*: negative externalities (which is addressed by prudential regulation) and information asymmetries (which is addressed by market regulation)[38].

I. Hampering of the aims of market regulation[39] through information asymmetries

60. Asymmetric information refers to a situation in which one group of market participants has more or better information than another, and the former has incentives to exploit that advantage to the detriment of the latter. Three types of information asymmetry are described below. Each type can lead a failure to act in the client's best interest, poor levels of market transparency, or market abuse. The materialisation of any of these problems will tend to hamper the aims of market regulation.

61. The magnitude of informational gaps in the *commodity derivative*s sector varies according to the relative differences in knowledge and experience between transacting parties. In general, the informational gap increases as we move down the following list of types of participants:

    a) firms that are commercially active in the underlying physical *commodity market*: e.g. producers or wholesale suppliers with derivative trading functions;

    b) financial institutions active in *commodity derivatives markets* and in the underlying physical markets;

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[37] This section does not prejudge the outcome of the market failure analysis that will be conducted in the CESR-ERGEG context.

[38] The European Commission is separately examining another potential market failure relating to the structure of energy markets. In September 2007 the Commission published proposed new legislation that seeks to resolve structural failings in the electricity and gas markets.

[39] Market regulation is taken to include conduct of business rules, client asset rules, conflict management requirements, transaction and trade reporting obligations, and anti-market abuse rules (and the organisational requirements to ensure that firms comply with market regulation).

c) financial institutions active in *commodity derivatives markets* but not in the underlying physical markets;

d) corporate purchasers of *commodity derivative*s for hedging or investment purposes;

e) individuals – most likely for investment purposes and through indirect participation, for example via a pension fund.

1. Information asymmetries and failure to act in the client's best interest

62. As is the case in other financial markets, information asymmetries between firms and their clients are more marked for unsophisticated clients than for *sophisticated* clients. Unsophisticated investors are unlikely to seek out sufficient information, and matters are exacerbated in commodities markets by the fact that some *commodity derivative* contracts are subject to special price curves, making it difficult for unsophisticated investors to understand or evaluate information related to these contracts.

63. As indicated in the market description in Part A of this consultation paper, there is almost a complete absence of direct investment by those at the bottom of the informational hierarchy: unsophisticated individuals/private clients. This is not indicative of a market failure but rather reflects the fact that significant direct investment in *commodity derivative*s may not be appropriate for the overwhelming majority of unsophisticated private clients. Only very wealthy private clients have sufficient assets to manage a diversified portfolio of *commodity derivative* instruments themselves, given the size of most underlying contracts. Unsophisticated private clients may therefore prefer to limit their risk and reduce transaction costs by investing in professionally managed *commodity derivative* funds such as Exchange Traded Funds (ETF), or to invest in Exchange Traded Notes (ETN) or Exchange Traded Commodities (ETC). While this form of investment by unsophisticated private clients may increase in the foreseeable future, these services are:

a) provided by regulated brokers and banks, and hence clients receive the benefits of *MiFID* protection;[40]

b) not generally provided by *specialist commodity derivative firms* directly to unsophisticated private clients.

64. Nevertheless, some types of unsophisticated investors participate directly in *commodity derivatives markets*. This is generally limited to corporate producers and wholesale distributors. While these firms may be experienced in trading in physical *commodity markets*, they may lack sufficient experience and knowledge in derivatives markets and hence mis-selling risks arise.

Conclusion

65. The vast majority of participants in the *commodity derivatives markets* are *sophisticated* firms or unsophisticated (in relation to experience and knowledge in derivatives markets) corporate clients. Since information asymmetries between *sophisticated* firms are relatively small, the potential for

[40] FSA, 2007: Growth in commodity investment: risks and challenges for commodity market participants, March 2007

significant market failures due to information asymmetries is limited. Although there are likely to be greater information asymmetries when unsophisticated clients are involved, their direct participation in this sector is currently mainly limited to unsophisticated corporate clients with a lack of experience and knowledge in derivatives markets but not in trading in physical *commodity markets*. Nevertheless, some informational asymmetries may persist: as described above, participants may have informational advantages when they are active in both the *commodity derivatives markets* and commodity production or supply activities at the same time (e.g. electricity producers have the advantage of knowing in advance when the repair of a power plant will be finished and electricity produced by this plant will be available on the market again).

Questions

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?

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?

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

2. Information Asymmetries and Market Transparency[41]

66. Participants in the *commodity derivatives markets* could be subject to information asymmetries if there are structural impediments preventing certain firms from accessing certain types of underlying information, or if dealers publish less trade information than is optimal for the market as a whole because they do not take into consideration the benefits that such publication will confer on market participants other than themselves (a positive externality). This could inhibit the growth of the *commodity market*, resulting in sub-optimal levels of investment, and in the extreme could conceal market abusive trades (see below).

67. There are two main types of relevant information: information about trades in the derivatives markets and information about the underlying markets (including information on physical contracts and production figures). Although the derivatives and physical markets are discussed separately below, the

[41] Market transparency issues in this section refer to pre and post trade price and volume information

second part of CEBS's technical advice highlighted how financial and commodities markets overlap, are interrelated, and influence one another. For example, the collapse of Amaranth and the resulting increase in volatility in world-wide stock exchanges illustrate how conditions in one financial market can affect the mobility of capital between markets. Capital may be withdrawn from markets – including *commodity derivatives markets* – if the capital needs to be reallocated to other markets. For example, there is evidence that current strains in other financial markets affect capital flows in and out of commodity forward and *cash markets*. Some *institutions* have allegedly closed out *commodity derivative* positions to increase liquidity needed to meet margin calls in other financial markets; conversely others are reportedly increasing investment in commodities and *commodity derivative*s as a refuge from wider financial turmoil and as an inflation hedge.

a. Derivative markets

68. In the shorter-term, more commoditised end of the derivatives market, business is often conducted on exchanges, and transparency standards are therefore high. Trading on *MTF*s is also generally transparent. Market data are also available from commercial data services such as Bloomberg and Reuters.

69. However, as described above, a significant part of *commodity derivative* trading is conducted *OTC*, where prices and positions are more opaque. Nevertheless, most participants do not appear to be deterred from participating in these markets. Complaints about a lack of transparency by market participants can be a sign of a market failure. Discussions with market participants in the United Kingdom suggest that most large participants do not have any significant issues with transparency in *commodity derivatives markets*; we welcome the views of other market participants in question 5 below.

b. Physical markets

70. As stated in the *second part of CEBS's technical advice*, the most active participants in *commodity derivatives markets* tend to be price optimisers who have 'natural' long or short positions as a result of their main business in the underlying physical market. They use *commodity derivative*s to optimise their business – whether as producer or purchaser – by profiting from changes in the price of the underlying commodity. For example, in Norway, two thirds of *commodity derivative* trades are completed by firms that also trade in the underlying commodities on *cash market*s. In the United Kingdom, approximately 60% of FSA-authorised firms engaging in *commodity derivative* investment activities also have commercial operations in the underlying physical market. In the Netherlands, 'Program Responsible Parties' (*energy* producers and distributors that have 'shipping agreements' with the national grid operator) receive information on the future capacity of the national grid directly from the grid operator. Market parties without these shipping agreements (such as investment firms) have no immediate access to this information and depend on delayed publication of this information on the grid operator's website.

71. Organisations with commercial operations in the physical markets clearly have an informational advantage over other participants in the derivatives markets. Some market participants view this as a natural economic 'rent' accruing to firms that have invested to be major players in the underlying, and indeed

many financial firms are seeking to, or have already entered the underlying markets. Financial regulation does not prohibit them from doing so, although the scale of investment required may deter some smaller financial firms. The distribution of some types of information from some of these markets is governed by the regulators of the physical markets. However, some of the information is private and not readily acquired; for example, traders who are also producers may take advantage of the fact that only they know about their future production and supply plans. In the German electricity market, an initiative by *energy* producers seeks to achieve better transparency concerning production capacities.[42]

72. When considering informational advantages arising from trading in the physical market, it is worth distinguishing between information that is in the public domain but that participants may choose not to expend resources to obtain, for example because the costs are substantial as in the case of Genscape); and information that is not in the public domain. The latter generates market abuse concerns as well, and this topic is explored below. Analysts and specialist press publications may alleviate informational asymmetries arising from the physical market.

73. Market participants in the *commodity derivatives markets* have emphasised the importance of understanding the structure and operation of the underlying markets in order to use the derivatives markets properly. It is important to keep abreast of current developments that could move the markets, such as macroeconomic data on the effect of Chinese growth rates on the demand for copper, or information on the capacity constraints of European gas pipeline networks. Without such broad market understanding and knowledge, greater transparency in the derivatives markets would achieve little. Initial discussions with market participants did not indicate that there was any way that changes to derivatives transparency could be employed to 'backfill' a lack of knowledge about the underlying market.

Conclusion

74. The significance of *OTC commodity derivatives markets*, combined with lower associated market transparency, raises potential concerns about information asymmetries. In practice, regulated trading firms have not voiced this as a major concern which deters them from participating in the markets. However, CEBS and CESR are interested in hearing the views of a wider audience, including the clients of regulated firms.

Question

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

3. Information asymmetries and market abuse

[42] Cf. certain EEX press releases, e.g. as of 21 May 2007.

75. Information asymmetries can also result in market abuse, which can take the form of insider dealing or market manipulation. Market abuse can lead to a loss of market confidence, tending to increase the risk premium (returns) demanded by investors for continued market participation, which in turn raises the cost of capital and results in sub-optimal levels of investment.

76. The risks of improper conduct in *commodity derivatives markets* are similar to those in other financial markets. However, there are specific issues in *commodity derivatives markets* related to the interplay between the *commodity derivatives markets* and the market in the underlying commodity that give rise to market abuse concerns.

77. In general, insider trading involves a market participant trading on information in breach of a fiduciary obligation, or trading on information that has been misappropriated. However, *commodity derivatives markets* are slightly different from other markets in terms of what constitutes inside information. Many producers of commodities engage in derivative transactions. These producers may have information from the underlying commodity production and supply activities. Derivatives trading based on knowledge of the production and supply activities should not generally be regarded as an inappropriate use of information if that information is publicly available. These issues are reflected in the separate definition of inside information for *commodity derivative*s in the Market Abuse Directive.

78. Another potential problem is market manipulation: the deliberate attempt by market participants to profit by undertaking trades or spreading misinformation that creates a false impression of supply and demand conditions. In particular, the interplay between the *commodity derivatives markets* and the *cash market* in the underlying commodity can lead to manipulation if the commodity is storable. A manipulator can 'corner' and 'squeeze' the *commodity market*. This allows him to raise prices to his advantage.

79. When 'cornering' a market, a manipulator builds up large positions in the underlying *cash market* for the commodity in order to create an artificial shortage. This is usually done in conjunction with long positions in the *futures* market. The manipulator then demands delivery of the commodity (squeezes the market). Since he simultaneously withholds his stock of supply, the sellers of the futures will find it difficult to acquire enough of the commodity to fulfil their contracts. The manipulator can then use his market power on the *commodity market* to charge high prices for his stock of the commodity.

80. There have been some recent high-profile cases alleging market abuse in the *commodity derivative* sector. For example, BP America has entered a deferred prosecution agreement with the U.S. Department of Justice under which the company admits that it manipulated the price of February 2004 TET physical propane and attempted to manipulate the price of TET propane in April 2003. The Commodity Futures Trading Commission (CFTC) Order settling the charges against BP Products, North America Inc. found that employees of that company cornered the TET propane market for the objective of dictating prices to other market participants in order to obtain a significant trading profit.

81. Informational asymmetries in *OTC* markets can give rise to market failure: unscrupulous participants can use such asymmetries to cloak market

manipulation activities, generating incentives to trade on less transparent venues. For example, the Norwegian FSA has investigated suspected cases of market manipulation in the electricity derivatives market. One example is the potential to manipulate the closing prices of exchange-traded derivatives. If mark-to-market methods are used to value the open interest for each member, then the manipulator may be able to influence the valuation of its own (and others') portfolio to its own advantage. For instance, the value of an option with a forward as an underlying is valued at the closing price of the forward on a particular day. If the closing price is manipulated, then the option can become more profitable.

Conclusion

82. *Commodity derivatives markets*, like other financial markets, are subject to informational asymmetries which can give rise to abusive market conduct.

Question

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

II. Hampering of the aims of prudential regulation[43] through negative externalities

83. Negative externalities are present when the production or consumption of a good or service imposes costs on economic agents (people or firms) other than the original producers or consumers and those effects are not fully reflected in market prices. Of particular relevance is the concern that the failures of firms providing investment services may have negative externalities on other market participants. Depending on their severity, such externalities can have systemic or non-systemic consequences. The following observations on systemic risk supplement the *second part of CEBS's technical advice* (Section III – Systemic risks and risk mitigants).

84. Systemic risks represent a significant threat to financial stability and market confidence. One type of systemic risk is the possibility that the failure of a firm or firms threatens the stability of a system. 'System' can be defined in a broad sense (the entire economy or financial system) or in narrower senses (specific markets, which may be further divided into sub-systems). Systemic risk arises because of firms' interdependencies with other firms, which may be direct (due to inter-firm exposures) or indirect (due to exposures to the same or highly correlated assets). While systemic risk concerns historically have focused on the banking sector, some non-bank financial institutions (as well as non-financial firms) are so large and have such extensive cross-sector interdependencies that their failure might lead to systemic consequences. When examining systemic risks generated by *commodity derivative*s business, concerns are likely to be proportionate to the size and the volatility of *commodity markets* and the size of the major players in those markets, which

[43] Prudential regulation is taken to include rules governing a firm's capital resource requirements as well as the organisational requirements (e.g. risk management) to ensure that firms comply with prudential regulation.

can be contrasted with the size of other financial markets, and with the level of exposures between the two.

1. Impact on Financial Markets

85. As indicated in the *second part of CEBS's technical advice*, there are three types of exposures through which contagion can be directly transmitted from participants in *commodity derivatives markets* to the wider financial system:

    a) credit risk exposures – through credit institutions' lending and providing collateral and guarantees to *commodity market* participants;

    b) credit risk exposures – through *CCR* exposures; and

    c) equity risk exposures – as a result of *institutions* having an ownership interest in commodity firms. Parent companies often assume some of the credit risk of their subsidiaries, for example through parent company support and in some cases guarantees.

86. The existence of these interconnections means that the failure of a specialist *commodity derivatives* firm can directly affect other financial players and financial markets. The *second part of CEBS's technical advice* concluded that:

    > "...there are significant mechanisms/relationships in place between the markets for commodities or exotic underlyings and the related industry on the one hand and the wider financial markets on the other hand. This gives rise to systemic risk concerns though these may depend on the size of the markets for commodity derivatives relative to either the wider financial market or the related industry."

87. Systemic concerns can arise from the first two types of exposures listed above, i.e. lending and trading. The most material form of exposures, however, is not lending but counterparty credit risk to market participants, including to *specialised commodity derivatives firms*. Both forms tend to be of a lower order between *specialist commodity derivative firms* and *institutions*, when compared to the interconnections between *institutions* themselves. Credit risk and *CCR* exposures arising from lending by credit institutions to *specialist commodity derivative firms* can be assessed in the same way as exposures to other types of clients of credit institutions.[44]

88. Additional systemic concerns arise from the indirect interdependencies between commodities markets and the wider financial system. These indirect interdependencies result from price and spread movements caused by failures of market participants in a commodities market, which could have an impact on *ISD* investment firms or credit institutions that have invested in these markets.

89. Trading interconnections are relatively limited, because the share of commodities business of *institutions* in relation to total trading is relatively small. For example, the total outstanding notional value of *OTC* contracts in

[44] One member of the task force considers this assertion to be misleading. In his opinion: a) the assertion seems to assume that all institutions are active in more markets than specialist *commodity derivatives* firms, b) the risk of lending exposures differs from that of lending to a 'normal' undertaking which generates returns by 'normal' production activities, and c) the business activities of such 'normal' undertakings typically do not involve the level of market risk and counterparty credit risk that specialist *commodity derivative* firms are exposed to.

the G10 countries and Switzerland is estimated at $516 trillion, of which $7.5 trillion (1.5%) is in commodities[45]. The vast majority of derivative trading involves *institutions* trading contracts whose underlying is an interest rate, equity, debt, or foreign exchange product, although some of the consequential *CCR* exposures are to *specialist commodity derivative firms.*

90. This does not mean, however, that *institutions* are not exposed to significant losses in these markets, since volatility in commodities markets can lead to unexpected market price or spread changes, resulting in losses that are disproportionately high relative to their participation in these markets. In addition, interconnections between *specialist commodity derivative firms* and *institutions* are likely to be more extensive than the relative size of commodities markets might suggest, as, in addition to *CCR* relating to commodities business, such *institutions* will also have *CCR* exposures to *specialist commodity derivative firms* in other types of instruments such as interest rate and foreign exchange derivatives.

Question

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

91. Specialist *commodity derivative* firms occupy a different position within the financial system compared to (other) *institutions*, and this difference has systemic risk implications. In addition to trading on their own account, *specialist commodity derivative firms* traditionally have focused on exploiting arbitrage and proprietary trading opportunities arising out of their commercial clients' desire to optimise prices for the respective commodity[46].

92. In contrast, banks play a pivotal role in the economy, accepting retail and wholesale deposits, managing the payment system, and providing finance for a large number of borrowers. This role may result in cross-market contagion in the event of difficulties and is the main risk that prudential regulation of credit *institutions* seeks to address. As *specialist commodity derivative firms* do not perform these functions, they do not raise the related concerns.

93. The negative externalities associated with *ISD* investment firms are different from those arising from *specialist commodity derivatives firms*. Most investment firms are active in many financial markets, resulting in extensive cross-firm and cross-sector exposures. From a systemic risk perspective, this has mixed implications. On the one hand, it may result in diversification benefits and thus reduce the probability of failure. On the other hand, care should be taken not to over-estimate these benefits, as correlations between markets may be significantly higher in times of crisis – that is, at the very time when systemic risks are liable to materialise[47].

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[45] Bank of International Settlements: Semi-annual *OTC* derivatives statistics at end-June 2007.
[46] BIS Quarterly Review, March 2007
[47] See De Bandt, O. and P. Hartman (2000), "Systemic Risk: a Survey", ECB Working Paper 35, European Central Bank

94. In addition, *ISD* investment firms have become key participants in domestic and international clearance and settlement processes in derivatives, securities, and foreign exchange markets. The increased prevalence of financial groups and the adoption of diversified financial business models have resulted in the integration of deposit taking and securities business. The result is that the failure of an investment firm is likely to have systemic implications greater than those generated by the failure of a *specialist commodity derivatives firm* of the same size.

95. Some studies[48] [49] have suggested that the greater the potential support from the central bank in case of liquidity crises, the lower the liquidity buffer *institutions* hold. In principle, *specialist commodity derivative firms* are less likely than other financial institutions – such as deposit-taking banks and large investment firms – to receive central bank support in times of distress. If there were an implicit guarantee from the central bank, this would limit the costs of financial distress and reduce the costs of external financing in banks and investment firms relative to *specialist commodity derivatives firms.* [50]

96. The perceived systemic risk posed by large investment firms was recently illustrated when the Federal Reserve Board voted unanimously to authorise the Federal Reserve Bank of New York to create a lending facility to improve the ability of primary dealers to provide financing to participants in securitisation markets[51].

97. So far there have been no cases in which interconnections between *specialist commodity derivative firms* and other financial *institutions* have led to significant financial instability. For example, the collapse of the Amaranth hedge fund in September 2006 did not raise substantial systemic stability concerns. Similarly, problems at Sumitomo, Enron, Metallgesellschaft, or indeed at any other individual investment firm participating in *commodity derivatives markets*, do not appear to have threatened systemic financial stability. However, these markets do present the risk of sizeable losses – indeed various brokers incurred significant losses in the Sumitomo event. Even when a firm's failure does not lead to a systemic crisis, it may have a negative impact on market confidence. It should be kept in mind that these are only historical observations, and that growing participation by *institutions* in commodity derivatives markets might alter the risk landscape.

2. Impact on Underlying Markets

98. Some specialist *commodity derivative*s firms also produce or supply commodities, at least on a group level. They trade primarily in order to manage their group's natural long or short positions in certain commodities, in addition to achieving gains from trading in these commodities. The failure of such firms, in addition to generating credit losses for their counterparties, could affect the price and availability of commodities. It could also have implications for related markets: for example, for products requiring commodity inputs, or for broader markets such as *energy* markets.

[48] See Repullo (2005), "Liquidity, risk taking and the lender of lat resort", International Journal of Central Banking, September. Available at: http://www.ijcb.org/journal/ijcb05q3a2.htm
[49] Aspachs, O., Nier, E., Tiesset, M., (2005), "Liquidity, banking regulation and the macroeconomy", mimeo.

[51] 16 March 2008. See http://www.federalreserve.gov/newsevents/press/monetary/20080316a.htm

99. The activities of purely speculative investors can have different impacts on the market, depending on their investment strategies and on broader market conditions. Their trading may raise or lower prices, and can also have an impact on price volatility. If the investors are proactive and engage in speculative trading they may increase volatility; however, if they are reactive and provide market liquidity they may reduce volatility.

100. It should be noted, however, that several large bankruptcies in *energy* trading markets, including Enron, Transworld Oil, and Gatt Oil, had only a limited effect on *energy* supply. In electricity markets, this is mainly because grid managers are required to provide sufficient balancing electricity in all circumstances. It can also be assumed that other market participants stepped in to assume the natural position of the defaulted participants, or adjusted their own natural position by changing production processes or plans. Security of supply is traditionally the focus of the physical regulators.

101. Nevertheless, firm failure can have a significant price impact and may temporarily lead to higher or lower prices in the underlying *commodity market*. For example Amaranth's failure is estimated to have resulted in an $18 billion increase in consumers' *energy* bills[52]. A sharp raise in prices was also observed in the German electricity market following the failure of Enron.

Conclusion

102. Although connections do exist between *specialist commodity derivative firms* and broader financial markets, systemic risks generated by these firms appear to be relatively low compared to the systemic risks generated by banks and *ISD* investment firms[53]. Indeed, even if the risks arising from commodities business are not different from those arising in the wider financial markets, the financial impact of a failure from a *specialist commodity derivative firms* appear to be lower than an equivalent failure from a financial institution.

Responses to the Call for Evidence

103. Five respondents to the CEBS/CESR Call for Evidence stated that they see little or no evidence of market failure. Although the sixth respondent did explicitly raise market failure concerns, on examination these are best regarded as regulatory failure issues, as they concern competitive distortions allegedly caused by current regulatory regimes.

<u>Questions</u>

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

[52] US government-commissioned investigative report concerning the events leading up to the collapse of Amaranth Advisors LLC

[53] See also the *second part of CEBS's technical advice*, paragraph 12: "From a prudential perspective systemic risk is the paramount concern. Systemic risk crystallises through contagion which transmits via market participants' direct and indirect interdependencies. The perceived interconnections between the markets for commodities or exotic underlyings and the related industry, on the one hand, and the wider financial markets, on the other hand, can give rise to systemic risk concerns though their magnitude appears significantly smaller relative to the systemic risks posed by banks and ISD financial investment firms. In the commodities case studies examined in this report, systemic concerns were limited and contained."

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?

Energy Firms

104. The Call for Advice asked CESR and CEBS to consider whether there is a case for establishing a distinct financial regulatory regime for *energy* investment firms. For example, the United Kingdom operates special, less demanding regimes for oil and *energy* market participants. We examine the following areas:

- The mix of participants and resulting informational asymmetries. While *energy* derivative markets do contain large numbers of specialist firms that deal to a large extent with sophisticated counterparties, this is not unique to *energy* markets. Indeed, some of the *energy* markets (e.g. emissions trading) may have a wider range of participants than other markets, such as metals.
- Systemic risks. There are no marked differences in the nature of the prudential risks generated by different *commodity derivative* classes. Indeed, given the complexities that arise from that fact that electricity is not storable, it is difficult to conclude that prudential and systemic risks are lower for *energy*-only firms.
- Nature of the firms. *Energy*-producing firms find it necessary to hold substantial fixed assets on the group's balance sheet, which provides a measure of prudential comfort. However, the trading *energy* entity will not necessarily have recourse to such fixed assets.

105. In conclusion, we have not uncovered compelling evidence that suggests that the risks generated by *energy*-only investment firms differ materially from those posed by investment firms engaging in other *commodity derivative* activities/services.

Question

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?

PART C. REGULATORY FAILURE ANALYSIS

106. Questions 2 and 3 of the Call for Advice are related to potential regulatory failure. Regulatory failure generally refers to a regulatory intervention whose net economic impact is negative or suboptimal. This is often due to unintended impacts which lead to disproportionate costs for market participants and/or competitive distortions.

Commission Questions

The Call for Advice asks the following questions:

"2) Do the differences in regulatory treatment between categories of firms that provide investment services in relation to *commodity derivative*s and across Member States give rise to a regulatory failure, by:

i) Creating significant competitive distortions;

ii) Significantly impairing the free movement of services between Member States; or

iii) Encouraging market participants to engage in a significant degree of regulatory arbitrage?

3) To the extent that market or regulatory failures are identified, can it be anticipated that such failures would be eradicated as a natural consequence of market evolution in the short to medium term?"

107. This Part begins with a brief description of the different regulatory treatments of firms and activities in *commodity derivatives markets*. It then analyses potential regulatory failures and considers whether they are material. The final two sections examine whether regulatory differences create distortions in the free movement of services between Member States and whether there is evidence of regulatory arbitrage.

I. Differential treatment of firms and activities in *commodity derivatives markets*

108. Under the current regulatory framework, some firms and activities in the *commodity derivative*s sector fall within the scope of the *MiFID* and *CRD* regulations and others do not. In principle, there are four types of regulatory regimes for *specialist commodity derivative firms*:

a) firms subject to *MiFID* and *CRD* requirements,

b) firms subject to the *MiFID* and the *CRD* but with a carve-out for *CRD* capital and/or large exposures requirements,

c) firms that are completely exempt from the *MiFID* , and

d) firms subject to specialist national regimes for certain markets (e.g. oil markets, *energy* markets)

109. Thus firms carrying out the same activities are not necessarily subject to the same regulatory regime. This could in principle cause competitive distortions. However, differential regulatory treatment does not necessarily mean there is regulatory failure, as there may be reasons why different treatment of some firms is appropriate.

110. In particular, differential treatment of firms can arise from differences in the transposition and implementation of applicable Directives across the EEA. This may give rise to a multitude of regulatory regimes throughout the EEA.

Box: *MiFID* and *CRD* Exemptions

The *MiFID* establishes a regulatory regime for persons who provide investment services or activities on a professional basis. However, Article 2 of the Directive exempts certain types of persons from the scope of the Directive, and thus from the general regime. In particular:

Article 2(1)(i) “exempts persons dealing on own account in financial instruments, or providing investment services in *commodity derivatives…*to the clients of their main business, provided this is an ancillary activity to their main business, when considered on a group basis, and that main business is not the provision of investment services within the meaning of the *MiFID* or banking services under Directive 2000/12/EC.”

Article 2(1)(k) “exempts persons whose main business consists of dealing on own account in commodities and/or *commodity derivative*s. This exemption shall not apply where the persons that deal on own account are a part of a group whose the main business is the provision of other investment services within the meaning of the *MiFID* or banking services under Directive 2000/12/EC.”

The *MiFID* exemptions and Article 38(4) of the *MiFID* Implementing Regulation are “expected to exclude significant numbers of commercial producers and consumers of *energy* and other commodities, including *energy* suppliers, commodity merchants and their subsidiaries” from the regime (recital 22 of the *MiFID* Implementing Regulation).

The *CRD* imposes prudential requirements on all credit institutions and investment firms which reflect the specificity of the risks arising from their operations and the need to avoid potential competitive distortions. However, under Article 48(1) of the *CAD*, some *specialist commodity derivative firms* falling within the scope of the *MiFID* are transitionally exempted from the *CRD’s* capital requirements if their main business consists exclusively of providing investment services or activities relating to commodities business, Article 45 of the *CAD* grants the possibility for a transitional exemption with regard to the large exposures rules if those large exposures arise from commodities business.

II. Potential regulatory failures

111. The current regulatory regime could lead to regulatory failure if the differential treatment of market participants were not justified, or if the regulation were not appropriately tailored to the specific characteristics of *commodity derivatives markets*.

112. This section discusses the following potential areas of regulatory failure:

a) market transparency,

b) market integrity (transaction reporting and market abuse),

c) client categorisation,

d) regulation according to the main business of the group,

e) definition of financial instruments,

f) capital requirements, and

g) large exposures

113. The section concludes with some general observations on whether the current regulation of *commodity derivatives markets* is sufficiently clear and well-adapted to the specific characteristics of the market.

1. Market Transparency

114. This sub-section on market transparency is without prejudice to the advice expected from the Joint CESR/ERGEG Group on Energy.

115. As discussed in the market failure analysis in Part B, the relatively low transparency of *OTC commodity derivatives* markets may deter optimal levels of market participation and increase the risk premiums demanded by investors, raising the cost of capital. Thus it is worth considering whether the lack of transparency in *OTC* markets is a regulatory failure

116. The U.S. Commodity Exchange Act and the regulations promulgated by the U.S. CFTC under that Act provide an illustration of how this issue might be addressed. The CFTC publishes weekly 'Commitments of Traders' reports, which provide a breakdown of open interest for commodity futures markets in which 20 or more traders hold positions equal to or above reporting levels established by the CFTC[54]. These reports increase transparency in *commodity markets* and enhance the supervisory toolkit for identifying market trends and congestion in individual instruments. However, creating similar reports in Europe would require reporting mechanisms that could be costly to implement throughout the EU, particularly since data aggregation can be more difficult for *commodity markets* than for securities markets because closely correlated instruments are traded on different venues.

117. Participants in the *commodity derivatives markets* who responded to the Call for Evidence did not voice major concerns about the availability of information regarding pre- and post-trade prices and transaction volumes.

Question

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?

2. Market integrity (transaction reporting and market abuse)

118. This sub-section on transaction reporting and market abuse is without prejudice to the advice expected from the Joint CESR/ERGEG Group on Energy.

119. The market failure analysis in Part B indicated that market abuse can arise in the trading of *commodity derivative*s. Issues of market integrity are therefore of relevance in the *commodity derivatives markets*.

[54] For more information about the Commodity Futures Trading Commission's reports see http://www.cftc.gov/marketreports/commitmentsoftraders/cot_about.html

120. The *MiFID* requires investment firms to report to competent authorities transactions they conduct in instruments that are admitted to trading on regulated markets, whether or not the transactions actually take place on a regulated market.

121. In many jurisdictions, the *MiFID* requirement has meant that investment firms were placed for the first time under an obligation to report transactions relating to *commodity derivative*s. To facilitate the introduction of this new obligation, it was agreed that transactions in non-securities derivatives (including *commodity derivative*s) would be reported through the respective regulated markets (although investment firms could still opt to report to the competent authority directly). Market operators have undertaken to report trading on their markets to their local regulator.

122. Transaction reporting serves several purposes for supervisors. It helps protect market integrity; helps supervisors monitor investment firms' compliance with conduct of business obligations such as best execution; helps supervisors monitor investment firms' compliance with pre- and post-trade transparency requirements (note that there are no transparency requirements for investment firms in relation to *commodity derivative*s); and helps supervisors monitor market trends.

123. In practice, protecting market integrity has usually been considered the most important of these purposes, although the *MiFID* may have changed this to some extent by abolishing the concentration rule and applying best execution to all financial instruments. However, transaction reporting may have only limited usefulness in this respect. The *MiFID* transaction reporting requirements for *commodity derivative*s provide only a fragmented picture of trading activity and the behaviour of market participants. They do not cover trading outside regulated markets (unless the instrument being traded is admitted to trading on a regulated market).

124. Furthermore, as described in the market failure analysis in Part B, manipulators in commodities markets may take advantage of the interplay between the derivatives market and the *cash market* in the underlying commodity to attempt to corner or squeeze the market. Position reports are acknowledged as the standard tool for monitoring these markets, whereas transaction reports alone do not provide the information required to detect this type of abuse.

125. Given the MiFID's coverage and exemptions, it is likely that transaction reporting would yield only limited benefits, and at a significant cost.

126. The U.S. regulation of *commodity markets* requires brokerage firms and other relevant entities to report both transactions and positions of large traders, either to the exchange or to the market operator. Moreover, record-keeping requirements ensure that data regarding *OTC* positions and transactions are accessible to the CFTC to the extent that the *OTC* activities are related to instruments traded on authorised trading venues[55].

127. If the Commission is inclined to consider a more ambitious move toward a comprehensive set of transaction and position reporting and record-keeping

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[55] For more information of the Commodity Futures Trading Commission's reports see
http://www.cftc.gov/marketreports/commitmentsoftraders/cot_about.html
http://www.cftc.gov/marketreports/commitmentsoftraders/index.htm

requirements, a more detailed cost/benefit analysis could be conducted. The UK Financial Services Authority recently performed a cost/benefit analysis on establishing CFTC-style Commitment of Traders reports, and concluded that the limited market demand for this information was significantly outweighed by the considerable cost.

Question

12) 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?

128. Market abuse could also arise from the lack of transparency in *OTC* markets, which may create incentives to trade on less transparent venues. As discussed in the market failure analysis in Part B, there are concerns in Norway that exchange prices could be manipulated in order to influence the prices of *OTC* contracts (where the largest market exposures are likely to be) that reference exchange prices. This raises the question whether these issues could also constitute regulatory failure with respect to market abuse.

129. The fact that commodities *MTF*s, which represent a non-negligible share of total *commodity derivative*s trading, are not covered by the Market Abuse Directive could also result in regulatory failure.

130. There has also been debate concerning the definition of 'inside information' in the Market Abuse Directive and in Article 4 of Directive 2004/72/EC. The European Securities Markets Expert Group (ESME) reported in 2007 on the EU Market Abuse legal framework and commented on the definition of inside information with respect to *commodity derivative*s.[56]

131. We generally believe, however, that issues related to market abuse should be addressed in the Commission's wider review of the Market Abuse Directive.

3. Client categorisation

132. As in other financial markets, the *MiFID* applies the principle of graduated client protection to *commodity derivatives markets*. It is important to recognise in this context that:

a) *commodity derivatives markets* are predominantly professional in nature. Unsophisticated private investors do not participate in these markets in significant numbers, although a significant number of unsophisticated corporate clients can be observed.

b) the characteristics of clients in *commodity derivatives markets* can be different from those of clients in other financial markets.

133. The boundary lines for professional clients established by the *MiFID* may not adequately reflect the client characteristics in *commodity derivatives*

[56] http://ec.europa.eu/internal_market/securities/docs/esme/mad_070706_en.pdf

markets. This creates two problems. On the one hand, it may be unnecessarily costly for investment service providers to service *sophisticated* market participants whom they are prevented from treating as professional clients. On the other hand, unsophisticated investors who are treated as professional clients may not receive the degree of protection they require.

134. This issue was raised by some respondents to the Commission's call for evidence, and also in some responses to the CEBS/CESR call for evidence.[57]

135. To the degree that client categorisation rules do not adequately reflect the specific characteristics of *commodity derivatives markets*, this may lead to competitive distortions and/or client protection issues.

Question

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?

4. Regulation according to the main business of the group

136. In some cases, whether a *specialist commodity derivative firm* is subject to or exempt from the *MiFID* depends not on the type of activity that the firm engages in, but on the characteristics of the firm's owner:

a) *commodity derivative*s affiliates of banking/financial services groups are generally subject to the *MiFID*;

b) *commodity derivative*s affiliates of non-financial firms trading in *commodity derivatives markets* are not necessarily subject to the *MiFID*.

137. This situation arises in part from the exemptions in Articles 2(1)(k) and 2(1)(i) of the *MiFID*:

a) when a *specialist commodity derivative*s *firm* provides investment services to firms that also happen to be clients of its main business, Article 2(1)(k) of the *MiFID* may result in lower compliance/regulatory costs, which may give it a competitive advantage relative to banks and investment firms that are subject to the *MiFID* and the *CRD*.

b) Exemption 2(1)(i) applies only if the firm's commodities business is ancillary to its main business and its main business is neither the provision of investment services nor banking services. If the firm is part of a group, the activities must be ancillary to the main business of the group, whose main business can be neither the provision of investment services nor banking services.

138. At the firm level, regulation according to the main business of the group leads to differential treatment of companies which conduct the same or similar business. This may be justified if regulation according to the main business of

[57] For a more detailed description of these responses see part D. IV. on client categorisation and conduct of business regulation.

the group captures differences in the systemic risk posed by the failure of a *specialist commodity derivative firm*. As discussed in the market failure analysis in Part B, systemic risks posed by *specialist commodity derivative firms* are generally lower than those generated by banks and *ISD* investment firms. The main business of the group in this case could serve as a proxy for the degree of systemic risk, for example in the application of capital requirements.

139. However, exemptions based to the main business of the group are not currently applied in targeted sense. They are applied with respect to *MiFID* requirements as a whole, rather than only with respect to capital requirements.

140. Regulatory failure could also result from differences in the interpretation and application of the *MiFID* exemptions across EU member states. (Chapter 1 of CESR's response to the Commission's request for initial assistance on *commodity derivative*s and related business describes the divergent interpretations of Article 2(1)(i) of the *MiFID*.) Such a regulatory failure might confer a competitive advantage on participants in *commodity derivatives markets* who are exempt from the *MiFID*.

Question

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

5. Definition of financial instruments

141. A key consideration in determining whether *MiFID* could give rise to regulatory failure is whether the *MiFID* definition of financial instruments is appropriate for *commodity derivatives markets*.

142. In deciding whether the *MiFID* definition of financial instruments is appropriate, it is important to recall the intent of this definition. Recital 4 of the *MiFID* provides that: "It is appropriate to include in the list of financial instruments certain *commodity derivative*s and others which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments."

143. This establishes a dividing line between products or contracts that resemble traditional financial instruments and are associated with the types of market failure that financial regulation seeks to address – which are within the scope of the *MiFID* – and products or contracts that do not resemble traditional financial instruments or involve the same types of market failure – which are outside the scope of the *MiFID*. As discussed in the market failure analysis in Part B, asymmetric information and the possibility that it will lead to sub-optimal investment in certain products is a key regulatory concern.

144. The Commission's call for evidence on *commodity derivative*s specifically asked whether the scope of the definition of financial instruments in the *MiFID* as it relates to *commodity derivative*s is adequate. Most of the

respondents to this call for evidence thought the definition is adequate and does not require amendment.

145. Some respondents to the Call for Evidence commented on the definition of financial instruments. These responses, and the more general issue of whether the definition is adequate, are discussed in more detail in Section V of Part D of this consultation paper.

6. Capital Requirements

146. Capital requirements can be seen as a way of dealing with the negative externalities (systemic risk) associated with the failure of financial firms (see the discussion of market failure in Part B). Systemic risk arguments are usually concerned with the possibility that the failure of a specific firm or set of firms might undermine the stability of the overall financial system.

147. A key determinant of the breadth and depth of a shock and its potential to become systemic is the extent of the firm's interdependency with other firms, in its own market as well as in other markets. In commodities business, such interdependencies may be heightened by counterparty credit risk exposures on derivatives, payment and settlement relationships on physical commodities and derivatives, and the existence of large exposures on underlying assets or commodities. In recent years, the interdependencies between different participants in *commodity markets* have increased due to the growing participation of banks, *ISD* investment firms, and institutional investors, including hedge funds, in *commodity derivatives markets*.

148. Capital requirements play a significant role in ensuring a competitive market for financial services and activities. The application of a common set of capital rules prevents some firms from profiting from a less burdensome regulatory regime. It has been argued that the temporary exemption provided by Article 48 of the *CAD* may create competitive distortions in the *commodity derivatives markets*. *Specialist commodity derivative firms* exempted from the *CRD's* capital requirements may be able to avoid regulatory capital requirements and thereby benefit from a competitive advantage compared to other *ISD* investment firms or banks offering the same financial services or activities relating to certain commodity or exotic underlyings. Thus it could be argued that extending the scope of the current *CRD* could lead to equal treatment for firms acting in the *commodity derivatives markets* and at the same time address potential systemic risks arising from the activities of the currently unregulated entities.

149. However, this argument does not by itself justify extending the scope of the *CRD* to include all firms operating in the market. Regulation brings net economic benefits only where it addresses potential market failures. The arguments for extending the *CRD* may not take fully into account the particularities of *specialist commodity derivative firms*, including the fact that the systemic risks arising from specialist commodity traders appear to be lower than those stemming from banks and *ISD* investment firms.

150. Some evidence for this last statement is provided by recent high-profile failures in the *commodity derivatives markets*, such as Enron and Amaranth. Although these firms were quite large, the impact of their failure on systemic stability and investor protection was relatively contained. This suggests that while *specialist commodity derivative firms* may face the same types of risks

as banks and investment firms, the externalities arising from the interdependencies between *specialist commodity derivative firms* are different from those posed by other financial firms.

151. Even if the failure of a *specialist commodity derivative firm* would not lead to a systemic crisis, it may nonetheless have a negative impact on parts of the overall system and on market confidence. Firms dealing with *commodity derivative*s take on credit, market, and operational risks. Inadequate management of these risks could lead to firm failures and investor losses, both of which have the potential to impair market confidence and disrupt the economy more broadly, without necessarily implying systemic risk consequences. These risks could require some form of prudential oversight.

152. The *MiFID* and *CRD* exemptions do not preclude Member States from imposing specific regulatory regimes on the exempted entities. For example, in the United Kingdom, some *commodity market* participants are or can be exempted from applying *CRD* prudential requirements:

1. Oil Market Participants (OMPs) are not required to apply capital rules as long as they are not trading members of a recognised or designated exchange.
2. Energy Market Participants (EMPs) whose main business consists of the generation, production, storage, distribution, and/or transmission of *energy* and who are not already covered by the statutory exemption from FSA regulation (as is the case for those involved in some gas and electricity industry activities[58]) can apply to the FSA for a waiver from prudential requirements. Energy is defined as coal, electricity, natural gas (or any by-product or form of any of them), and oil.

153. OMP and EMP firms are also subject to less onerous conduct of business requirements if they confine their investment services and activities to oil/*energy* investments or products, and they do not deal with retail clients.

154. These restrictions are designed to limit the risks arising from asymmetric information and to limit systemic risks. The potential risks arising from OMP/EMP firms are managed by strictly limiting which firms can qualify for these regimes.

155. The special OMP/EMP prudential regimes tend to have a lighter touch, reflecting the specific nature of the specialist *commodity derivative*s business, its lower systemic consequences, and the fact that customers in these UK markets tend to be *sophisticated*. However, the existence of different special regimes in different countries would raise the possibility of a patchwork of regulatory regimes with divergent interpretations of the exemptions. On the whole, 'gold-plating' practices may contribute to create competitive distortions and encourage regulatory arbitrage practices.

156. In conclusion, *specialist commodity derivative firms* generally seem not to pose the same level of systemic risk as banks and *ISD* investment firms, and therefore might not warrant the same degree of prudential regulation. The full application of the *CRD* to *specialist commodity derivatives firms* is

[58] Under paragraphs 42 and 49 of the Schedule to the Financial Services and Markets Act (Exemption) Order 2001, which exemption has a MiFID counterpart in Article 38(4) of the MiFID Regulation (EC 1287/2006).

therefore likely to impose a regulatory burden that is disproportionate to their potential systemic impact. However, as discussed in the market failure analysis in Part B, negative externalities can still be present and may justify the imposition of some prudential requirements beyond those to which exempted firms are subject.

7. Large exposures

157. Large exposures rules, like prudential regimes more generally, are aimed at addressing the systemic risk associated with negative externalities. Many *specialist commodity derivative firms* structure themselves as subsidiaries of large commodity producing or trading companies traders. These *specialist commodity derivative firms* normally are not accepted as market participants on their own, but "free ride" on the back of parent company support

158. The preceding discussion concluded that the systemic risks generated by these firms are of a lower order than those posed by banks and *ISD* investment firms. Consequently, the benefits of applying a large exposures regime to these firms could also be lower. Furthermore, due to the prevalence of group structures in which the authorised entity acts as an intermediary between the group to which it belongs and the market, the application of a large exposures regime is likely to impose significant costs.

159. These costs would be accentuated by the fact that commodity trading is almost always connected to high-volume credit exposures. Large credit exposures and free deliveries in commodities business arise from common market practices such as providing goods in large quantities and charging for them later, and not from lending practices.

160. These implications are currently reflected in the Article 45 *CAD* exemption, which enables supervisory authorities to assess how well trading firms manage their counterparty risks on an individual basis, and to allow *specialist commodity derivative firms* to exceed large exposure limits without additional capital requirements.

Questions

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?

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?

Conclusion

161. The potential regulatory failures relating to prudential and conduct of business requirements, described above, generally are due to rules that are not adapted to the specific nature of the *commodity derivatives markets*.

162. Furthermore, the EEA currently has a patchwork of different regulations. Regulatory differences arise because of:

a) super-equivalence with respect to EU rules (e.g. special *energy* and oil market regimes in the United Kingdom);

b) different implementation of EU rules (Chapter 1 of CESR's Response to the Commission's request for initial assistance on *commodity derivative*s and related business describes the divergent interpretations across EU member states of Article 2(1)(i) of the *MiFID*); or

c) different rules in areas that are not covered by EU legislation (as described in the first part of CEBS's technical advice)

163. These differences in the interpretation and implementation of EU rules result in significant regulatory failure, indicating the need for convergence. Regulatory failure creates competitive distortions as well as the potential for regulatory arbitrage (see below), and runs counter to the goal of creating a single European market for *commodity derivative*s business.

164. It is unlikely that the market will able to correct these regulatory failures in the short to medium term, since the failures stem from *MiFID* provisions and/or from differences in regulatory treatment across the EEA.

III. Free movement of services

165. Because there is currently a direct link between the free movement of services and being subject to the *MiFID*, firms falling within the exemptions of Article 2 of the *MiFID* – unlike competing banks and investment firms, which are subject to the *MiFID* – will not benefit from the 'passport' which allows them to provide services throughout the EEA.

166. German firms have raised this issue as a potential distortion and claimed there should be no link between the application of the *MiFID/CRD* and the ability to benefit from the free movement of services.

IV. Regulatory arbitrage

167. Firms may be able to take advantage of significant differences between regulatory regimes through regulatory arbitrage.

168. Cross-border regulatory arbitrage occurs when firms take advantage of differences in regulatory systems across EU Member States. We are aware of several recent cases of cross-border regulatory arbitrage:

a) A large Dutch *energy* producer recently moved its trading desk to Geneva. The implementation of the Markets in Financial Instruments Directive played a role in this decision.

b) A significant UK trader in *commodity derivatives markets* cancelled its authorisation and moved its trading business to another EU member state, where its trading business is not currently subject to capital requirements. As it is still subject to the *MiFID*, the firm can use its passport rights to continue conducting business in the United Kingdom.

169. More generally exemptions from regulation may lead to a situation where only a subset of market participants is regulated. In these cases it may be possible to cherry pick between being subject to or being exempted from regulation..

Question

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

Responses to the Call for Evidence

170. The responses to question 2 of the Commission's Call for Advice (relating to competitive distortions) were mixed. Two respondents stated that there are competitive distortions, while two others argued this not to be the case. One respondent argued that there are no competitive distortions on a national level, but that local requirements significantly impair cross-border competition and result in regulatory arbitrage. Two other respondents mentioned regulatory arbitrage, stating that firms may seek out jurisdictions with lighter regulation for their business. However, they did not state that this could lead to competitive distortions. Two respondents questioned the wisdom of making the application of *MiFID* exemptions depend on whether the firm is part of a financial group or not.

171. The respondents providing answers to question 3 of the Commission's Call for Advice argued that market and/or regulatory failures in the market will not correct themselves in the short to medium term.

Part D. *MiFID* Questions 4 to 6

Commission Questions

4) Based on the response to questions 1 and 3 above and on their initial advice, do CESR and CEBS consider that the MiFID and CAD treatment of firms providing investment services relating to commodity derivatives and exotic derivatives continues to support the intended aims of market and prudential regulation? Please consider at a minimum the following aspects:

d) the obligation to uphold integrity of markets and to comply with the organisational requirements and conduct of business obligations incumbent upon investment firms as per MiFID;

e) the criteria for determining which instruments are to be treated as having the characteristics of other derivative instruments, or as being for commercial purposes or which fall within Section C (10) of Annex I to MiFID if the other criteria set out in that Section are satisfied in relation to them (c.f. Article 40 (2) of the MiFID Implementing Regulation);

I. Pre-trade and post-trade transparency

172. The *MiFID* imposes only limited obligations with respect to the pre-trade and post-trade transparency of the price and volume of trading in *commodity derivative*s. Both regulated markets and *MTF*s are required to have rules and

procedures for 'fair and orderly' trading[59], while *MTF*s have to make available, or be satisfied that their users can access, sufficient information to make investment judgements[60]. There are no pre-trade or post-trade transparency obligations for investment firms with respect to *commodity derivative*s.

173. In its summary of the responses to its Call for Evidence on the review of *commodity derivative*s[61], the Commission noted that there was no enthusiasm for extending to *commodity derivative*s the type of pre-trade and post-trade transparency arrangements that apply to shares under the *MiFID*. To the extent that respondents thought there was a role for regulatory intervention in this area, it was mainly to suggest the disclosure of aggregate data by trading venues.

174. Part 2 of the market failure analysis in Part B highlighted the current lack of concern among traders regarding the degree of pre-trade and post-trade transparency. Part 1 of the regulatory failure analysis highlighted concerns about the possible costs of greater transparency. We therefore do not believe it is appropriate at this stage for us to make any proposals relating to pre-trade and post-trade transparency for non-electricity and gas *derivative*s, although this is obviously an issue that should continue to be monitored. Further analysis and a relevant question are included in Part 1 of the regulatory failure analysis in Part C of this consultation paper.

II. Market integrity (transaction reporting and market abuse)

175. See the discussion in Part 2 of the regulatory failure analysis, above.

III. Organisational requirements

176. Articles 13 and 18 of the *MiFID* (and the related implementing measures in Chapter II of the implementing directive[62]) set forth organisational requirements designed to ensure that firms meet their regulatory obligations and that the interests of their clients are protected. These requirements deal with:

a) effective compliance, risk management, and business continuity arrangements;

b) control over outsourcing arrangements;

c) client money and asset rules;

d) record-keeping; and

e) management of conflicts of interest.

177. In the main, the *MiFID*'s organisational requirements are expressed at the level of principles. They are meant to apply in different ways – particularly as they relate to firms' internal systems and controls – depending upon the nature, scale, and complexity of the firm and the nature and range of

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[59] Articles 39(d) and 14(1) of Directive 2004/39/EC
[60] Article 14(2) of Directive 2004/39/EC
[61] Published on 14 August 2007 and available at:
http://ec.europa.eu/internal_market/securities/isd/mifid_reports_en.htm
[62] Directive 2006/73/EC

investment services and activities undertaken in the course of that business. None of the responses to our Call for Evidence commented directly on these organisational requirements.

178. We believe that the organisational requirements of the *MiFID* support the intended aims of market regulation of investment firms providing investment services relating to *commodity derivative*s. The issues they deal with are of relevance to such firms and their clients, even if the specific organisational solutions for the provision of investment services may vary from those for other types of financial instruments. We are not aware that Articles 13 and 18 of the *MiFID* and their associated implementing measures confront investment firms that provide investment services relating to *commodity derivative*s with any particular difficulties related to the nature of *commodity derivative*s business.

Question

> **18) 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 derivative*s business? If not, what aspects of the organisational requirements do you believe do not support the aims of market regulation when applied to such firms and why?**

IV. Client categorisation and conduct of business regulation

179. The client categorisation regime and the conduct of business rules in the *MiFID* are the means by which the *MiFID* seeks to ensure that investors receive an adequate level of protection. The two should be viewed together rather than separately. The application of the conduct of business rules to any given client depends on the client's categorisation. There is also significant flexibility within the client categorisation rules for clients to vary their categorisation so that they can tailor the protections they receive under the conduct of business rules.

180. All of the respondents to the Commission's call for evidence on *commodity derivative*s agreed that activities giving rise to similar investor protection concerns should be subject to the same regulation. But many respondents also argued that the investor protection issues that arise in the *commodity derivatives markets* are not the same as in other financial markets because most participants in *commodity derivatives markets* are 'sophisticated'. That is, these participants should be in a position to assess the risks inherent in the transactions they enter into because – unlike in other financial markets – they are entering into transactions to manage commercial risks rather than for investment or speculative purposes.

181. Some of the respondents to the Commission's Call for Evidence suggested that the client categorisation rules in the *MiFID* do not necessarily reflect the 'sophisticated' nature of *commodity derivatives markets*. Commercial entities have to meet either the size criteria in Annex II (I) of the directive or the qualitative and quantitative criteria in Annex II (II) of the directive in order to be considered as professional clients and have the option

of opting up to eligible counterparty status. Some respondents said that the size criteria in Annex II (I) can be difficult to satisfy for subsidiaries, and that the qualitative and quantitative criteria in Annex II (II) are aimed at individuals rather than entities. They argued for changing the client categorisation rules in the *MiFID*. One response also suggested that the benefits of the elective eligible counterparty regime are undermined by the fact that Article 24(3) of the *MiFID* allows the Member State in which an undertaking is based to determine whether an investment firm in another jurisdiction can treat relevant clients as elective eligible counterparties.

182. Some of the same points were made in response to our Call for Evidence. In addition, one respondent to our Call for Evidence offered a specific suggestion for changing the client categorisation regime for *commodity derivative* business. This respondent recommended:

a) allowing investment firms to treat undertakings as professionals if they are part of groups that meet the existing size thresholds on a consolidated basis;

b) considering firms whose shares are listed on European markets (or other markets with equivalent standards) as per se professional clients;

c) in relation to *commodity derivative*s business, including 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

183. As noted above, the client categorisation regime is central to the way the conduct of business regime in the *MiFID* operates. Because of this, and because the regime has only been in operation for a few months, it is appropriate to be cautious when considering possible changes to the regime. We certainly do not envisage any changes to the client categorisation regime that would alter the way in which the regime deals with individuals.

184. Significant concern has been expressed by the industry, as set out above, that the current rules could hinder the participation of some *sophisticated* clients in *commodity derivatives markets.* The description of EU *commodity derivatives markets* and the market failure analysis in the opening Parts of this consultation paper suggested that not all undertakings using *commodity derivatives markets* are necessarily *sophisticated* participants. The criteria in Annex II of the *MiFID*, which establish whether clients can be regarded as per se or elective professional clients, act as a proxy for determining the 'sophistication' of clients. Such a proxy is unavoidably imperfect. The key question for this review is whether the criteria offer adequate protection for unsophisticated clients while allowing *sophisticated* clients to look after themselves, thereby promoting the efficient operation of the markets and their attractiveness for international business.

185. The *MiFID's* categorisation regime is modified to some extent by Article 71(6) of the *MiFID*, which grants investment firms (across the full range of investment services) some flexibility to categorise existing professional clients as professional clients under the *MiFID* without applying the criteria in Annex II of the *MiFID* in full. A similar approach would appear to be appropriate if any firms are brought within the scope of the *MiFID* through this review.

186. The criteria in Annex II of the *MiFID* clearly will apply to new clients taken on after 1 November 2007. Therefore the impact that these criteria have on the *commodity derivatives markets* (and other financial markets) will increase over time.

187. We are interested in developing a better understanding of the potential problems perceived by some of the respondents to our Call for Evidence. There are two aspects to this question. First, to what extent are undertakings that participate in *commodity derivatives markets* likely to be required to be classified as retail clients forwarding the future? Second, do market structures in certain areas, such as in relation to users of forward freight agreements, create difficulties in applying the client categorisation criteria?

Questions

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?

188. The provisions of Articles 19, 21, and 24 of the *MiFID* seek to ensure an appropriate level of investor protection, and thus they support the aims of market regulation. They apply differently depending on the categorisation of clients, with retail clients receiving the highest level of protection. If clients in *commodity derivatives markets* are classified properly according to their knowledge, experience, and expertise, then there would not appear to be a problem with the operation of conduct of business rules in these markets. There will be fewer obligations for firms dealing with eligible counterparties and professional clients than for firms dealing with retail clients. We therefore do not believe that the conduct of business rules in the *MiFID* need to be adapted for *commodity derivative*s business as long as the client categorisation regime works adequately in these markets.

189. There was little comment on specific conduct of business issues in the responses to our Call for Evidence, beyond suggestions that conduct of business regulation is largely inappropriate in 'sophisticated' markets. Some concern was expressed, however, regarding the definition of 'investment advice', which it was argued is unclear. But to the extent that there is an issue, its scope is broader than advice relating to *commodity derivative*s, and we therefore do not consider it is appropriate to deal with it in this review.

Question

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?

V. Financial Instruments

190. Articles 38 and 39 of the *MiFID* Implementing Regulation set out the criteria that certain *commodity derivative*[63] contracts have to meet in order to be considered as having the characteristics of other derivative financial instruments (and, with respect to *commodity derivative*s strictly defined, as not being for commercial purposes), and therefore falling within the scope of the *MiFID*.

191. Most respondents to the Commission's Call for Evidence on *commodity derivative*s thought that the definition of financial instruments in the *MiFID* as it relates to *commodity derivative*s is adequate and does not require amendment. The responses to our Call for Evidence made the following points concerning the definition of financial instruments:

a) in some countries, it will be important to ensure that rules allowing netting are applied more broadly so as to apply to transactions that are not financial instruments within the scope of the *MiFID*;

b) the reference to freight rates is unclear insofar as a freight contract is not itself a commodity;

c) the term 'commercial' is not suitable for separating sensitive regulated activities from others which should not be regulated. The main criteria should be whether a company enters into a derivatives transaction (i) as an end-user who is hedging; (ii) to invest its own money, or (iii) as an investment firm.

192. Netting rules in individual Member States are outside the scope of this review. However, this is clearly an industry concern, as set out in a recent letter to the Commission[64], and needs to be considered in another context. The reference to freight rates appears in C(10) of section C of Annex I of the *MiFID*. This category of financial instruments covers exotic rather than *commodity derivative*s, strictly defined, and as such we do not believe that the reference is unclear. As noted below, the role that the term 'commercial' plays, on its own, in defining financial instruments is limited.

193. Articles 38 and 39 of the *MiFID* Implementing Regulation serve four main purposes with respect to the definition of financial instruments in the *MiFID*:

1. they provide additional clarity on the list of underlyings to which *exotic derivative*s relate (the *MiFID* Implementing Regulation also defines a 'commodity');

2. they ensure that all cash-settled[65] *exotic derivative*s contracts are included in the definition of financial instruments;

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[63] Annex I Section C of MiFID uses the term derivative in several places in setting out what are financial instruments under the directive. MiFID does not define what a derivative is. We do not believe that it would be helpful in this review, which is taking a limited look at the list of financial instruments, to consider the precise meaning of this term.

[64] See ISDA press release of 17 April at http://www.isda.org/press/presso41708netting.html

[65] A contract which is 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.

3. they ensure that all physically-settled[66] *exotic derivative* contracts traded on regulated markets and *MTF*s are included in the definition of financial instruments; and
4. they establish the criteria for determining when a physically-settled commodity derivative contract (other than contracts traded on a regulated market or an *MTF*) is a financial instrument.

194. There are several aspects to determining whether or not a physically-settled commodity derivative contract is a financial instrument under Articles 38 and 39. The first dividing line is whether or not the contract is a spot contract. Article 38(2) defines a spot contract as a contract under which delivery is scheduled to be made within the greater of two trading days and the period generally accepted in the market for the relevant underlying. If a contract is not a spot contract, then it is a financial instrument provided that it is a standardised contract subject to clearing house or margin arrangements and it falls into one of the following categories:

a) it is traded on a third-country market that is equivalent to a regulated market or *MTF*;

b) it is expressly stated to be traded on or subject to the rules of a regulated market, *MTF*, or an equivalent third country market;

c) it is expressly stated to be equivalent to a contract traded on a regulated market, *MTF*, or an equivalent third country market.

195. As indicated in the regulatory failure analysis in Part C, definitions of financial instruments can be considered to support the aims of financial services regulation when they capture products that are recognisably 'financial' and are associated with the same types of potential market failures as financial instruments: i.e. information asymmetries and/or negative externalities, both of which can result in sub-optimal levels of investment in the absence of regulation. It is also important that the definitions are clear enough to provide a reasonable degree of certainty regarding the boundaries of financial services regulation.

1. Clarity on the underlyings of *commodity derivative*s

196. The definition of commodity used in Article 38 of the *MiFID* Implementing Regulation (but found in Article 2(1)) provides a commonsense interpretation of the term. We are not aware of any concerns about the content of this definition. Concern has, however, been expressed about the fact that the definition appears to relate only to instruments covered by C(7) of Section C of Annex I of the *MiFID*, and not C(5) and C(6) as well. It would be more natural for 'commodity' to be defined in level 1 of the *MiFID* rather than in the *MiFID* Implementing Regulation, given the use of the term in Annex 1 of the level-1 directive. But in practice, given that the definition in the *MiFID* Implementing Regulation is close to the everyday natural meaning of the term 'commodity', we do not believe that this has led to supervisors applying different meanings to the word for different categories of financial instruments.

[66] A contract where there is no option for cash settlement other than by reason of default or other termination event.

197. Article 39 provides examples of the potential underlyings of *exotic derivative*s, including two generic categories – (f) and (g) – which ensure that innovation in *exotic derivative*s is not hampered by exhaustive descriptions of the underlyings in legislation. Again we are not aware of any concerns about this list.

2. Cash-settled *exotic derivative*s

198. The inclusion of all cash-settled *exotic derivative*s in the definition of financial instruments via Article 38(3)(a) of the *MiFID* Implementing Regulation parallels the inclusion of *commodity derivative*s in C(5) of Section C of Annex 1 of the *MiFID*. The logic for including cash-settled derivative instruments is that cash settlement in itself means that the instrument is 'financial' even if it is being used as part of commercial business.

3. *Exotic derivative*s traded on a regulated market or *MTF*

199. The inclusion of all *exotic derivative*s traded on regulated markets and *MTF*s in the definition of financial instruments via Article 38(3)(b) of the *MiFID* Implementing Regulation parallels the inclusion of *commodity derivative*s in C(6) of Section C of Annex I to the *MiFID*. The logic of this approach is that it ensures a consistent treatment of all comparable instruments traded on a regulated market or *MTF*, so that users can have the same confidence in all *commodity derivative* contracts that they trade on such an entity.

200. However, this approach raises two issues:

a) First, it means that there may be some physically-settled *commodity derivative* contracts which are financial instruments when traded on a regulated market or *MTF* but not when they are traded on an *OTC* basis. This might be argued to have potentially adverse consequences for the competitiveness of regulated markets and *MTF*s. However, it might undermine the status of regulated markets and *MTF*s if the same protections did not apply to all contracts traded on such entities.

b) Second, there is a degree of circularity in the *MiFID* definitions of financial instrument, regulated market, and *MTF*. Under C(6) of Section C of Annex I to the *MiFID* and Article 38(3)(b) of the *MiFID* Implementing Regulation, physically-settled *commodity derivative*s contracts are *MIFID* financial instruments when traded on a regulated market or *MTF*. In Article 4 of the *MiFID*, regulated markets and *MTF*s are defined as multilateral systems which trade financial instruments. In the light of these definitions, it is not clear whether or not a trading platform that admits to trading physically-settled *commodity derivative*s is trading financial instruments and must become a regulated market or *MTF*. In practice, this is probably not a very significant issue. In most cases it will be clear whether or not a trading platform is trading financial instruments and requires authorisation under the *MiFID*.

4. Physically-settled *commodity derivative*s[67]

[67] Many exotic derivatives will be cash-settled because the underlyings of these instruments, such as with weather derivatives, cannot be delivered.

201. Articles 38(1) and (2) of the *MiFID* Implementing Regulation set the boundaries that determine which physically-settled *commodity derivative*s contracts (that are not traded on regulated markets or *MTF*s) are financial instruments. They effectively complete the definition of physically-settled contracts that have the characteristics of other derivative financial instruments and, in the case of *commodity derivative*s strictly defined, are not for 'commercial purposes'.

202. Some of the responses to the Commission's Call for Evidence on *commodity derivative*s expressed concern about the use of the term 'commercial purposes'. The Commission stated that: "the commercial purpose seems to be a good test for most respondents; however some of them have mentioned the fact that the term 'commercial purpose' is open to a subjective interpretation which may be of concern in the application of the regulatory regime. This is why some respondents propose a clearer definition of what commercial purpose means."

203. Taken in isolation, the term 'commercial purpose' is open to interpretation. But in Article 38 of the *MiFID* Implementing Regulation, it does not stand alone. The Article sets objective tests which determine whether or not a contract has the characteristics of other derivative financial instruments and is not for commercial purposes. This approach differs from the approach in CESR's original advice on the *MiFID* implementing measures, which included indicative as well as determinative criteria on whether or not a contract is for commercial purposes. We therefore do not believe that the use of the term 'commercial purpose' creates problems of interpretation.

204. The criteria for determining which physically-settled *commodity derivative*s contracts (other than those traded on regulated markets or *MTF*s) are financial instruments are found in two articles of the *MiFID* Implementing Regulation:

a) Article 38(2), which defines physically-settled 'spot contracts', which are automatically not financial instruments;

b) Article 38(1), which determines when physically-settled contracts that are not spot contracts are financial instruments.

205. The definition of 'spot contract' is intended to exclude from the definition of financial instruments those contracts which are traded principally as part of commercial rather than financial services business. In a variety of commercial markets, products are traded at prices set today for delivery in the near future. How quickly delivery occurs depends on the nature of the product. It can vary widely, depending on how perishable the product is and on transport distances. Thus, rather than setting a uniform standard, the *MiFID* Implementing Regulation refers to the 'period [for delivery] generally accepted in the market for that commodity, asset or right as the standard delivery period'.

206. If a contract is not a spot contract, it must fulfil the criteria set out in Article 38, paragraph 1 of *MiFID implementing regulation* in order to be regarded as a financial instrument. This is intended to identify contracts that have the characteristics of other derivative instruments by linking inclusion to factors present in other derivatives markets, such as trading on organised markets, clearing, margining, and standardisation. The criteria are additive rather than stand-alone.

207. The definition of a spot contract in Article 38(2) of *MiFID implementing regulation*, together with the additive nature of the criteria in Article 38(1) of *MiFID implementing regulation*, are meant to ensure that the *MiFID* does not encroach on commercial (as opposed to financial services) business. The inclusion of physically-settled *commodity derivative*s (that are not traded on a regulated market or *MTF*) raises two main issues:

a) not all of the services/activities performed by investment firms are related to financial instruments; and

b) transactions can be deliberately structured to take them out of regulation (it will suffice to omit the express statement of equivalence for physically-settled *commodity derivative* contracts traded *OTC*).

208. There is inevitably a degree of arbitrariness in regulatory boundaries. There is often no bright dividing line which enables such boundaries to be easily drawn and widely accepted. If the boundaries follow the activities of banks and investment firms, this may risk creating unnecessary regulatory creep, extending regulation to activities for which the market failure rationale is weak or non-existent. Likewise, there is always likely to be some scope for structuring activities or contracts in such a way that they fall outside regulation even if they are economically equivalent to activities or contracts within the boundaries of regulation.

209. We currently have found no evidence that the application of the definition of physically-settled *commodity derivative*s contracts that are financial instruments is in any significant way allowing business that should be regulated to take place outside of the boundaries of the *MiFID*. In the absence of such evidence, and given the clarity and certainty provided by the *MiFID* Implementing Regulation, there does not appear to be any reason to revise the criteria in Article 38(1) and (2) of the *MiFID* Implementing Regulation.

Questions

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.

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?

Commission Question

5) Does the analysis above vary significantly depending on the type of entity providing the investment services or the underlying of the financial instrument? In particular does it differ for investment firms engaged in energy supply?

VI. Differences based on the type of entity

210. An earlier section of this consultation paper discussed whether the regulatory regime in the *CRD* and the *MiFID* should be altered for firms that specialise in investment services related to *commodity derivative*s. We see a case for differentiation with respect of the *CRD* but believe that adaptation of the *MiFID* (if any) should apply to all investment firms that provide investment services relating to *commodity derivative*s.

VII. Differences based on the underlying commodity, asset, right, service, or obligation

211. The responses to our Call for Evidence included two views on whether it is reasonable to distinguish between firms providing investment services or undertaking investment activities relating to different types of underlyings. Some respondents argued that a distinct approach was required for *energy* firms, because the key issues relating to *energy* are those of production and supply rather than the flow of capital, and because the use of derivatives markets is just one part of managing production and supply for these firms, which are very different from traditional financial services firms.

212. Other respondents argued, however, that the similarities between different *commodity derivatives markets* are more important than the differences, and that distinctions made between the regulatory regimes applying to different types of commodity or *exotic derivative* would be artificial.

213. We do not believe that it is appropriate to differentiate the regulatory regime based on the underlying commodity, asset, right, service, or obligation. Of course, this conclusion does not cover the issues being dealt with in the CESR/ERGEG review, which will not express a view on the desirability of a specific regime for *energy* derivatives.

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?

Commission Questions

6) In view of the above and their initial advice, what are the views of CESR and CEBS with respect to the following options or combination of options relating to the exemptions:

a) Issuing clarifying guidance as to the meaning of the various exemptions, and if so, with what content;

b) Maintaining the current scope and nature of exemptions from the relevant CAD and MiFID requirements for firms in the commodities sector: i.e. making the CAD exemption in Article 48(1) permanent, and maintaining the MiFID exemptions in Articles 2(1)(i) and (k) in place;

c) Studying the desirability of modifying the range of firms benefiting from exemptions and/or modifying the scope of the exemptions to cover more or fewer of the different requirements of the MiFID, and to apply the exemptions differently to certain commodities?

i) Defining the criteria for determining when an activity is to be considered as ancillary to the main business on a group level as well as for determining when an activity is provided in an incidental manner (Article 2(3) of the MiFID?

ii) Create a further category of investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the financial instruments in Section C5, 6, 7, 9 and 10 of Annex I of the MiFID relating to energy supplies(Article 48(2)(b) CAD);

d) Studying the desirability of making the existing exemptions optional for individual firms i.e. firms in principle exempted that wanted the MiFID passport could opt-in to the European regime by accepting MiFID and CAD regulation; while firms which remained exempt would remain with any applicable national regimes;

e) Studying the desirability of making the existing or proposed exemptions mandatory i.e. pre-empting Member States from regulating exempt firms under national rules relating to capital adequacy, organizational requirements and/or operating conditions;

f) Removing some or all of the exemptions entirely?

VIII. Articles 2(1) (i) and (k) of the *MiFID*

1. General considerations

214. We now turn to the scope of application of the *MiFID* to firms undertaking investment activities or providing investment services relating to *commodity derivative*s. Conclusions on this subject are linked to the *CRD* and *MiFID* regime that applies to *commodity derivative*s firms and business. Whether it is appropriate to bring certain firms under regulation depends on the regime that would apply to them if they were regulated.

215. Before discussing the options, it is necessary to note two uncertainties in the current situation relating to the exemptions:

a) First, CESR's previous advice indicated that there was a divergence of opinion among CESR members as to whether Article 2(1)(i) applies only to *commodity derivative*s business. The impact of retaining or eliminating the exemption obviously depends on how the exemption is interpreted.

b) Second, we do not have a clear picture of the number of firms that currently benefit from the exemptions. In most Member States, such firms fall outside of regulation altogether, so information on how many firms are affected is necessarily imcomplete. CEBS tried to collect some information in its earlier reports on this subject. The information received was patchy and could not be broken down by individual exemption. This uncertainty unavoidably makes it difficult to assess the impact of the exemptions and of any possible changes to them.

216. The respondents to the Commission's Call for Evidence provided varying views on the exemptions in 2(1)(i) and (k). Most of the producers/traders thought that the exemptions, if implemented consistently across Member States, would not create a competitive distortion. However, many of the financial services industry representatives and some of the government authorities considered that the exemptions gave rise to significant competitive distortions.

217. The respondents to our call for evidence also expressed different views on the desirability of retaining the exemptions in Articles 2(1) (i) and (k) of the *MiFID*. Our call for evidence had cited two main arguments for retaining the exemptions:

a) First, that while the exemptions did not produce a completely consistent regulatory regime, they did help to ensure a proportionate regulatory regime for the trading of *commodity derivative*s given the nature of the participants in these markets.

b) Second, insufficient time had passed since *MiFID* implementation to assess the impact of the new regime on the trading of *commodity derivative*s.

218. ISDA-FOA-EFET's Commodity Derivatives Working Group (CDWG) argued that the exemptions in the second limb of Article 2(1)(i) and in Article 2(1)(k) should be replaced by an exemption covering:

> "...persons (other than the operators of an *MTF* or regulated market) whose main business consists of dealing on own account with professional counterparties in relation to commodities and/or commodity derivatives or other non-financial derivatives."

219. The CDWG made several suggestions concerning the application of the exemption:

- the definition of 'professional' used for the exemption should be broader than the current definition of professional client in the *MiFID*;

- it should apply to an entity's activities when dealing on own account in the financial instruments (including when they deal for own account by executing client orders);
- it should be possible to combine the new exemption with other exemptions;
- firms eligible for the exemption should be allowed to opt in to regulation under the *MiFID*;

220. Some members of the group thought the exemption should cover more activities than dealing on own account, provided those activities are ancillary to the firm's main business. They argued that this approach to the exemptions would ensure consistent regulation of investment services while avoiding regulation of firms that are active in sophisticated markets and whose activities do not pose a significant threat to regulatory objectives and therefore do not need to be regulated.

221. Respondents supported making regulatory boundaries for *specialist commodity derivative firms* consistent across the EU by making the relevant exemptions in the *MiFID* mandatory.

222. The options in the Commission's question 6, above, effectively reduce to three different possible approaches to the exemptions in Articles 2(1)(i) and (k) of the *MiFID*:

1. retaining the exemptions;
2. modifying the range of firms benefiting from the exemptions;
3. eliminating the exemptions.

223. The first two broad approaches can be combined with some or all of the other elements covered in the options: clarifying guidance, optionality, and the harmonisation of regulatory boundaries across Member States.

224. **Clarifying guidance** Responses to both the Commission's and our Call for Evidence expressed a clear desire to have a regime for the regulation of *commodity derivative*s which is legally certain and consistent throughout the EU. This suggests that, whichever of the three broad approaches above is chosen, there should be sufficient clarifying guidance to enable market participants to determine with a reasonable degree of certainty if they would be regulated. Such certainty probably requires either an interpretative communication from the Commission or CESR level-3 guidance.

225. **Optionality** The retention of the exemptions may also mean that there are some firms that wish to take advantage of the *MiFID* passport but that are unable to do so. This would cause some degree of impairment to cross-border trade; the degree of impairment would depend on whether Member States regulate firms exempt from the *MiFID* on a national basis. If there is no such national regulation, then there should be no need for exempted firms to 'opt in' in order to benefit from the passport. This becomes an issue only if firms face national licensing regimes.

226. Regulation exists to achieve certain objectives, such as consumer protection, market confidence, and financial stability. The boundaries of regulation seek to define the activities which need to be subject to regulation in order to promote those objectives. If we do not believe that firms covered

by the exemptions need to be regulated in order to meet financial services objectives, it does not seem persuasive to allow them to opt in to regulation in response to market access concerns, other than by requesting permission to undertake regulated activities.

227. **Harmonisation** The harmonisation of regulatory boundaries across Member States is intended to simplify the patchwork of regulation across the EU and reduce barriers and distortions to cross-border trading. This goes beyond the ability of firms simply to exercise their right of establishment under the treaty. However, there may be a question of the extent to which a single market directive can harmonise the regulation of firms which are exempted from its scope as opposed to the regulation of firms within its scope, and thus whether Member States can be compelled to exempt from regulation firms who fall within the *MiFID* exemptions.

2. Options

a. Retaining the exemptions

228. As noted above, one of the respondents to our Call for Evidence suggested that it was too early to determine whether there was a case for modifying the exemptions. Leaving the exemptions as they are would enable the *MiFID* regime to 'settle in' across the EU and allow time to see clearly what problems, if any, the current form of the regulation may cause.

229. The *MiFID* has been operational for only a few months. Previously, the regulation of *commodity derivative*s varied across Member States. For example, the United Kingdom has regulated such business since 1988 and has 21 specialist *commodity derivative*s firms that are exempt from the *MiFID* but subject to regulation in the United Kingdom. The United Kingdom has seen very significant growth in *commodity derivative*s business under this regime in the last 20 years, and it remains a major global centre for *commodity derivative*s trading. This suggests that regulation of *commodity derivative*s firms that is broader than under the *MiFID* does not necessarily have adverse consequences for derivatives or physical trading, although the United Kingdom has applied prudential and conduct of business regimes which are less strict than full application of the *CRD* and the *MiFID*.

230. The regulation of *commodity derivative*s business has been a topic of discussion in the EU since the turn of the century, when debate got under way about revising the *ISD*. Thus postponing a decision on the appropriateness of the Article 2(1)(i) and (k) exemptions would extend what has already been a lengthy period of uncertainty regarding the regulation of *commodity derivative*s business. Decisions emerging from this review need to ensure that a regulatory regime for *commodity derivative*s is put in place which will provide a period of certainty for market participants.

231. The European Commission's original rationale[68] for the exemptions which became Articles 2(1) (i) and (k) was twofold:

a) to reflect the specificities of trading in *commodity derivatives markets*, and in particular the presence of participants trading on own account as part of running a primarily non-financial business;

b) to accommodate the lack of consensus on the prudential arrangements that should apply to *specialist commodity derivatives firms*.

232. The first justification for the exemptions obviously still applies, in that – as noted in the market failure analysis in Part B – *commodity derivatives markets* still have a very significant number of participants who are primarily non-financial businesses. But there is an issue of whether exemptions of the breadth of those in Articles 2(1)(i) and (k) are necessary to achieve this objective. The second rationale will obviously disappear if an agreement is reached on the prudential treatment of firms that currently benefit from the exemption in Article 48 of the *CRD*.

233. The regulatory failure analysis in Part C of this paper pointed to a problem with the exemptions. It does not seem logical to determine (as the exemptions do) whether a firm providing investment services relating to *commodity derivative*s is within the scope of the *MiFID* on the basis of the main business of the group rather than on the basis of the service being offered or the activity being performed.

234. In the light of the original rationale for the exemptions and the conclusion of the regulatory failure analysis in Part C, there is a case for considering whether to amend or abolish the exemptions.

b. Modifying the exemptions

235. The main advantage of modifying the exemptions is that it would create a specific prudential regime for *specialist commodity derivative firms* and address the regulatory failure that arises when the exemptions applying only to firms that are not part of a wider financial services group. We do not believe that it is appropriate to apply the exemptions differently to firms undertaking business relating to *commodity derivative*s, with different underlyings. This would create needless complexity.

236. As noted above, ISDA-FOA-EFET's CDWG have offered specific suggestions for modifying the exemptions. Their proposal raises a number of issues, including:

a) **Client categorisation** The CDWG's proposal to broaden the definition of 'professional' for the purposes of the exemption (this is the word used in the CDWG's proposal) is implicitly premised on a change in the client categorisation regime, since it would be odd if the

[68] This description is based on the document the Commission produced when it made the original proposal for the directive (published on 19 November 2002 and available at: http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm) which became MiFID. It therefore needs to be borne in mind that the Commission's comments do not necessarily fully reflect the exemptions which emerged as a result of the process of negotiation.

use of 'professional' for purposes of the exemption differed from the use that is made of that term for client categorisation purposes for *commodity derivative*s business.

b) **Executing client orders**. The CDWG proposes that the exemption should encompass the execution of client orders when dealing on own account. The exclusion therefore assumes that no conduct of business issues are raised by such activities when dealing with 'professional clients'.

c) **Investment services** Some members of the CDWG want the exemption to cover activities or services other than dealing on own account, provided they are ancillary to the firm's main business. This again assumes that no regulatory issues are raised by the provision of these services.

c. Eliminating the exemptions

237. Eliminating the exemptions in Articles 2(1)(i) and (k) would treat *commodity derivative*s business in the same way as other financial services activity. Firms performing the same activities in relation to all types of financial instrument would be treated in the same way when it came to determining whether their activities required them to be regulated under the *MiFID*. Such an approach implicitly assumes that undertaking investment activities and performing investment services relating to *commodity derivative*s raises the same regulatory issues as trading in other financial instruments.

238. Abolishing the exemptions in Articles 2(1)(i) and (k) would not require all participants in *commodity derivatives markets* to be regulated. Firms could still benefit from the other exemptions set forth in Article 2 of the *MiFID*. However, these exemptions are not specifically directed at the *commodity derivative*s business, which could cause some difficulties, particularly in relation to Article 2(1)(c) and (d).

239. The 'incidental' exemption in Article 2(1)(c) is likely to be of strictly limited relevance to the *commodity derivative*s business. It covers[69] only persons such as tax advisers or lawyers who are members of a profession regulated by legal or regulatory provisions or a code of ethics. Those providing investment services relating to *commodity derivative*s in an incidental manner are more likely to include entities such as ship brokers and agricultural co-operatives, whose main business is related to the underlying commodities. Currently, such firms might be exempt by virtue of the second limb of Article 2(1)(i). Abolition of the exemptions in Article 2(1)(i) and 2(1)(k) might force entities such as ship brokers and agricultural co-ops to stop providing investment services relating to *commodity derivative*s.

240. Concern has been expressed by market participants that the exemption in Article 2(1)(d) is 'quite limited' (the Commission has said of Article 2(1)(d),

[69] See the response to Question 3.1 on the Commission's Your questions on MiFID available at: http://ec.europa.eu/internal_market/securities/isd/questions/index_en.htm

"this exemption should be regarded as a very restricted one")[70]. ISDA-FOA-EFET have said that their firms "do not generally feel they can rely on the Article 2(1) (d) exemption. CDWG member firms generally perceive a lack of clarity as to either whether they would qualify as market makers, or if they would be caught by the other exceptions in exemption Article 2(1)(d)."

241. Beyond the issue of what constitutes a market maker (as defined in Article 4 of the *MiFID*, this term is not limited to firms that are designated as market makers under the rules of regulated markets or *MTF*s), there are two main parts of Article 2(1)(d) that may give rise to a lack of clarity. The first is, what dealing on own account on an *OTC* basis on an "organised, frequent and systematic" basis means. For example, how many trades in a quarter or a year constitute 'frequent dealing'? The second issue is what "providing a system accessible to third parties" means. For example, does it include a dedicated telephone number or an IT system owned by a third party operated by 'arranging companies' within and for a group that trades in *commodity derivative*s?

242. It is also important to have more clarity on whether firms may combine the exemptions, and in particular whether the exemption in Article 2(1)(d) may be combined with other exemptions. The greater the flexibility there is to combine exemptions, the more likely it is that primarily non-financial businesses could remain outside the *MiFID* without being forced into regulatory-driven subsidiarisation. CESR members believe that it is permissible to combine exemptions, but it is likely that firms will need greater clarity on this issue.

Conclusion

243. The exemptions in Articles 2(1)(i) and (k) of the *MiFID* were intended, at least in part, to provide a temporary solution to the lack of a specific capital regime for *specialist commodity derivative firms*. In conjunction with the development of an appropriate capital regime for such firms, it is appropriate that the exemptions be revised. We therefore do not believe that the exemptions should be left as they are.

244. *Commodity derivatives markets* differ from other financial markets by virtue of the significant involvement of non-financial firms that use the markets as part of their commercial strategies, to manage the risks in their business and thereby optimise the prices of their non-financial products. There is therefore a case for treating *commodity derivatives markets* differently from other financial services markets, and for modifying the exemptions in Articles 2(1)(i) and (k) rather than simply abolishing them. Relying on the other exemptions, such as that those in Article 2(1)(c) and (d), which have not been drafted specifically for these markets, may create unnecessary uncertainty with regard to their scope and application both alone and combined.

245. On balance, we believe 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. This might involve replacing Article 2(1)(i) and (k) with

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[70] See response to Question 40 on the Commission's Your questions on MiFID available at: http://ec.europa.eu/internal_market/securities/isd/questions/index_en.htm

a new exemption which more clearly deals with this issue than the general own-account trading exemption in 2(1)(d) or the exemptions relating to investment services that are incidental and subordinated to other non-financial services. However, any such exemption would need to be consistent with the investor protection and market efficiency objectives of the *MiFID*.

Question

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*?

Part E. CRD Questions 4 to 6

I. Does the *MiFID* and *CAD* treatment of firms providing investment services relating to *commodity derivatives* continue to support the intended aims of prudential regulation?

Commissions Question:

4) Based on the response to questions 1 and 3 above and on their initial advice, do CESR and CEBS consider that the *MiFID* and *CAD* treatment of firms providing investment services relating to *commodity derivatives* and *exotic derivatives* continues to support the intended aims of market and prudential regulation? Please consider at a minimum the following aspects:

a) The application of the *CAD* large exposures and free deliveries treatment to commodities related transactions in the light of the commodities market practices in particular, in light of the shortcomings set out in Part C of the *second part of CEBS's technical advice*?

b) The method for calculating capital requirements for commodities risk set out in Annex IV of Directive 2006/49 in particular in the light of the shortcomings set out in Part C of the *second part of CEBS's technical advice*?

c) The requirements for the use of internal models to calculate the capital requirements for commodities risk according to Annex V of Directive 2006/49 in particular in light of the shortcomings set out in Part C of the *second part of CEBS's technical advice*

Commissions Question:

5) Does the analysis above vary significantly depending on the type of entity providing the investment services or the underlying of the financial instrument? In particular does it differ for investment firms engaged in *energy* supply?

246. Prudential regulation has three major aims: protecting depositors, protecting investors (retail, professional and counterparties), and ensuring the stability of the financial system.

247. Recital 6 of Directive 2006/48/EC states that in order to protect depositors, all institutions whose main business is to receive repayable funds from the public and to grant credits for their own account shall be covered by the Directive. It could be argued that some firms that do not fall within this category also impact depositor interests, at least to some extent. However, the market and regulatory failure analysis in this paper clearly indicates that neither the firms exempted from regulation under the *MiFID* nor those

exempted from the *CAD* have a significant impact on depositors. Thus this aim of prudential regulation is not brought into play by these firms.

248. Recital 12 of the *CAD* states that „The own funds of investment firms or credit institutions (hereinafter referred to collectively as 'institutions') can serve to absorb losses which are not matched by a sufficient volume of profits, to ensure the continuity of institutions and to protect investors." This goes hand in hand with Recital 31 of the *MiFID*: "One of the objectives of this Directive is to protect investors. Measures to protect investors should be adapted to the particularities of each category of investors (retail, professional and counterparties). This aim of prudential regulation is clearly brought into play by specialist *commodity derivative*s firms, whether they are exempted under the *MiFID* or the *CAD* or not, since they raise counterparty protection issues. When a *specialist commodity derivatives firm* conducts derivative transactions in commodities markets, other market participants become counterparties of this firm. Such transactions therefore generate counterparty credit risk exposures of these counterparties to the *specialist commodity derivative firm*. And although there is very little private client participation in commodities markets, a significant fraction of clients of *specialist commodity derivative firms*, at least in certain commodities markets, are unsophisticated, mostly corporate investors.

249. The situation regarding the stability of the financial system is more complex. The *second part of CEBS's technical advice* concluded:

"*The perceived interconnections between the markets for commodities or exotic underlyings and the related industry, on the one hand, and the wider financial markets, on the other hand, can give rise to systemic risk concerns though their magnitude appears significantly smaller relative to the systemic risks posed by banks and ISD financial investment firms. In the commodities case studies examined in this report, systemic concerns were limited and contained.*"

250. The market and regulatory failure analysis in response to questions 1 and 2 of the Call for Advice support this conclusion:

251. "*In conclusion, specialist commodity derivative firms generally do not to pose the same level of systemic risk as banks and ISD investment firms and therefore might not warrant the same degree of prudential regulation. The full application of CRD on specialist commodity derivatives firms would likely impose a regulatory burden that is misaligned with their potential systemic impact. However, as described in the Market Failure Analysis, negative externalities can still be present and may justify the imposition of prudential requirements that the current regulatory framework does not require.*"

252. The analysis in this paper indicates that there is no straightforward answer to the question whether the current *CAD* treatment supports the intended aims of prudential regulation. The different options are discussed in Part II below.

1. The application of the *CAD* large exposures and free deliveries treatment to commodities related transactions in the light of the *commodity market* practices, and in

particular, in light of the shortcomings set out in Part C of the second part of CEBS's technical advice

253. As requested by the Commission's Call for Advice, this section deals with the *CAD* large exposure and free deliveries treatment as an isolated issue. It is important to note that this is one element of a regulatory regime and that, depending on the other elements of a comprehensive new or adapted regulatory regime, the findings on the application of large exposure rules could change.

254. Note also that the exemption from large exposure provisions does not affect private investors, as Article 45(1)(b) of the *CAD* limits its scope of application to firms that do not conduct business for or on behalf of retail clients. However, this does not necessarily exclude business with unsophisticated corporate clients.

255. One of the peculiarities of credit exposures in *commodity markets* (described in Part C of the *second part of CEBS's technical advice*) is that commodity trading is inevitably connected to high-volume credit exposures: free deliveries (as defined in Annex II, Section 2 of the *CAD*) arise as a consequence of the normal practices in major *commodity markets* (electricity, gas, coal). Pre-settlement risks caused by *CCR* exposures are also significant, due to the practice of entering into long-term contracts with high volumes. The pricing of such large positions is sensitive to even small price changes. The resulting risk in the *OTC* market is commonly not mitigated by interim invoicing or margining. Parent company support may provide some protection for the counterparties of such traders. The degree of such protection and its regulatory recognition depends among other things on the creditworthiness of the parent company, the firmness of the guarantee, and the obligation for prompt payment of the total outstanding liabilities.

256. Such exposures resulting from free deliveries are unavoidable for *specialist commodity derivatives firms* under current market practices, whereby such firms use non-cleared and non-margined physical settlement. A unilateral change in these practices appears unlikely in a transaction chain from producers via traders to consumers. And given the liquidity of physical markets, financial instruments are to a great extent replaceable by physical contracts. For example, cross-commodity swaps are seen as pure commercial contracts, but they consist of two fix-floating swaps which are financial instruments, if sold separately.

257. Another reason for commonly incurred large exposures is that trading companies deliver commodities to their parent companies, but without cashing it in immediately. Thus the claims against the parent companies regularly exceed large exposure limits.

258. In conclusion, full application of large exposure rules would demand very significant amounts of capital for the commodities business. In particular, it would require significantly higher capital levels than *specialist commodity derivative firms* current hold. Moreover – as the market failure analysis in Part B concluded – the activities of *specialised commodity derivatives firms* do not generate significant systemic concerns. Thus the application of the *CRD* large exposures regime to *specialist commodity derivative firms* appears disproportionate, and it would appear appropriate to adopt an approach comparable to that of Article 45 of the *CAD*.

Additional Issues

259. There are some issues of a lack of risk sensitivity in the prudential methods, which result in an overestimation of risk.

260. Article 106 of *Directive 2006/48/EC* provides that 'exposures' for the purposes of large exposures rules shall not include exposures that are generated by transactions for the purchase or sale of securities and that are incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities, whichever is earlier. Thus, in the context of securities business, the large exposure rules accept market practices. This idea seems to be transferable to commodities business, even though the settlement periods in the normal course of business are longer.

261. As regards the capital requirements for free deliveries, Annex II, Section 2 of the *CAD* treats free deliveries as exposures during the time interval between delivery and due date of payment (regardless of the length of that interval). In this respect, there appears to be no need for adjustment. Where payments are regularly made more than 5 days past due, it may be more appropriate to extend the treatment as an exposure to a period that is more in line with market practices, rather than requiring a deduction from capital beginning five days past due.

Question

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?

2. The method for calculating capital requirements for commodities risk set out in Annex IV of the *CAD*, in particular in the light of the shortcomings set out in Part C of the second part of CEBS's technical advice

262. In response to questions 1 to 3 above, two general issues have been identified as sources for regulatory failures: (1) the fact the current regulatory situation in the EEA is a patchwork of different regulations and (2) rules that are not fitted to the specifics of the *commodity derivatives markets*. While the first is generally not an issue for market participants to which the *CAD* applies, the second is still an issue for these market participants.

a. Shortcomings in the maturity ladder approach

263. As explained in Part C of the *second part of CEBS's technical advice*, the industry has raised concerns on the method for calculating capital requirements for commodities risk, especially the maturity ladder approach set out in points 13 to 18 of Annex IV of the *CAD*. For the reasons given below, this approach does not suitable for at least certain commodities. Since this approach could lead either to overestimating or underestimating capital requirements, it could either cause unreasonable additional costs for the firms

concerned or jeopardise the protection provided by prudential capital requirements.

264. Supervisors may allow offsetting of positions that mature on the same date or, under certain circumstances, within 10 days of each other. The assumption underlying this treatment is that long and short positions for a given delivery date are perfectly correlated. This assumption is not correct for all commodities. For example, prices for electricity to be delivered during a certain hour of a certain day are typically different from delivery hour to delivery hour. Price movements for one delivery hour need not be correlated with price movements for another delivery hour, for example if the price movement solely reflects an increased forecast of demand for a certain hour. If offsetting of positions for delivery at the same date but at different delivery hours is allowed, the resulting capital requirement could be lower than appropriate for the market risk of such positions.

265. All of the rates applied (outright rate, carry rate, spread rate) are lump-sum assumptions with respect to the volatility of market prices, carry costs, spread volatility, and the market risk correlation of imperfectly matched positions in a given portfolio. While the assumptions underlying a standardised approach cannot be expected to be appropriate for the actual mix of assets in a given portfolio, it is reasonable to expect that those assumptions will reflect differences in the respective *commodity markets* and in the general fluctuations of volatilities in a given market. However, all of the rates applied are fixed, and as such cannot reflect such fluctuations. Although the extended maturity ladder approach provides for rudimentary differentiation between commodities, this is limited to a distinction between four broad types of commodities, each of which is still based on fixed rates. Since certain *commodity markets* tend to undergo significant fluctuations (caused for example by market liberalisation or by variations in total turnover or the number, type, and objectives of market participants), using static rates could result in overestimating or underestimating the market risk of positions in certain commodities.

266. As part of the maturity ladder approach, *physical position*s in a commodity are transformed into financial positions using spot prices. Forward prices reflect implicit assumptions on market price volatility, spread movements, and, where applicable, carrying costs. The maturity ladder approach seeks to separate the assumptions on market prices at a future date from other parameters. The maturity ladder approach recognises spot prices (which represent the current expectations of the market participants) as an objective indicator of future market prices. However, the maturity ladder approach does not allow the use of own indicators for other parameters. Instead – as is typical for a standardised approach – those parameters are set by the supervisor in the form of flat rates (outright rate, carry rate, spread rate). In effect, the resulting capital requirements are based on a kind of 'supervisory' forward price for the respective commodities, which is derived from spot prices by applying the prescribed supervisory rates. This approach has shortcomings for certain types of commodities:

a) A minor shortcoming is that the meaning of the term 'spot price' is not specified in the Directive. Although it would appear obvious that 'spot price' refers in this context to the price for the respective commodity in the *cash market*, participants in some *commodity*

markets use the term differently. For example, in the German electricity market, the term 'spot price' is used to refer to any price for any delivery date and hour within the current month.

b) A more important shortcoming arises from the need to calculate average spot prices for forward positions when a given commodity has different spot prices for different delivery periods. This requires a decision as to which delivery periods are comparable. For example, while the hour from 8 to 9 a.m. could be a typical peak hour from Monday to Friday, it could be an off-peak hour on weekends and thus not a comparable delivery period. The Directive is silent on how to make this decision in calculating the average spot price.

c) The most serious shortcoming, however, is that the spot prices from which this approach derives the market prices for future delivery are not always available. In order to be able to derive the market price for future delivery of a commodity from a spot price, that commodity must be available on the spot market for immediate delivery. Where this is the case, it can reasonably be assumed that the factors which influence the price of the commodity are reflected not only in the forward price, but also and in the same manner in the cash price for immediate delivery of the commodity. However, not all commodities provide for immediate delivery as an alternative to a delivery at a future date. This occurs when the underlying physical commodity is not storable or the amount that can be stored is very limited. Electricity and gas are examples of such commodities. Current spot prices for such commodities do not reflect assumptions on the spot prices on a future delivery date. Consequently, it is not possible to derive 'supervisory' forward prices for such commodities from current spot prices. Simply using the current forward price as an alternative to the current spot price would also be inappropriate, since these forward prices are based on implicit parameter assumptions, and those assumptions are also factored into the prescribed supervisory fixed rates. Thus these parameters would be factored in twice, and what is more, using different figures.

267. For these reasons, the maturity ladder approach – at least for non-storable or limited-storage commodities – is not an appropriate way to address supervisory concerns regarding implicit assumptions on parameters other than the market price on a future date. For the same reason, this approach is also inappropriate for the market risk of *exotic derivative*s, if their underlying is not storable.

268. Consideration should therefore be given to alternative approaches that do not use spot prices but still address supervisory concerns. The options include:

1. Allowing the use of the current forward price instead of the spot price for the calculation of market risk charges for *commodity derivative* positions under the maturity ladder approach when the underlying is non-storable or the amount of storage is so limited that it does not materially influence the spot price.
2. Developing an approach that does not depend solely on current forward prices, but instead derives forward prices from a price history

over a specified observation period. This approach arguably would generate more objective assessments of the relevant parameters. Although it was originally developed for the German electricity market, it is general and could be applied to any type of commodity or *exotic derivatives*. It is still a standardised approach, since the only inputs required by the institution are the respective volumes for distinct fulfilment intervals and the history of forward prices for each fulfilment interval. Concrete examples of how this approach could be incorporated into the *CAD* are given in Annex I.

Question

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?

b. Reporting requirements for ancillary agricultural commodities business

269. Another issue raised by the industry relates to reporting requirements for ancillary agricultural commodities business.

270. The problem in this context is that reporting requirements for small amounts of physical commodities appear to lead to disproportionate burden for small credit institutions carrying out ancillary agricultural commodities business. Some local credit institutions (mostly co-operatives) conduct commodities business as an ancillary business. This business is tailored to the needs of their agricultural clients and encompasses heating and fuel oil, seeds, fodder and fertilisers, and other materials. Current regulation requires that these items be included in monthly risk reporting, which requires that a monthly physical inventory of these items be taken. The respondent raising this issue claims that these monthly reporting requirements, and in particular the monthly physical inventory, are overly burdensome in relation to the size and risk of these positions (which are generally below €250,000 in exposure value).

271. Inventory reports of 12/2005, 3/2006, and 6/2006 indicate that commodity items in the inventory consist primarily of wheat, brewers' barley, corn, soy groats, heating oil, and fuels. Forward transactions are transacted primarily in brewers' barley, wheat, corn, and soy groats, and to a large extent have matching maturities coverage. The overall scope of commodities *forward transactions* is relatively small.

272. The monthly physical inventories of the commodities, the determination of the respective market prices, and the valuation and recording for capital requirements purposes involve considerable manual work which seems to be excessive in relation to the risk posed by this type of business. Some accommodation would appear appropriate. For example the frequency for reporting (capital) requirements could be reduced from monthly to semi-

annual for ancillary agricultural commodities business below a certain threshold (for example, €250,000 in exposure value).

c. Further shortcomings in the Directive

273. We note that the definition of financial instruments in Annex I, Section C of the *MiFID* is not entirely reflected in the *CRD*. The Joint Task Force has identified the following discrepancies:

i. Article 75 of Directive 2006/48/EC and Annex I, point 48, Annex IV, Title and points 3, 18, 20, 21 and Annex V, points 1 and 12 of the *CAD*

274. The provisions mentioned above contain the expressions 'commodity risk' or 'commodities risk'. Since for implementation of the *MiFID* the definition of financial instruments includes '*exotic derivative*s' as well, this wording should be replaced by "commodity derivatives risk" to make it clear that these provisions also apply to *exotic derivative* risk.

ii. Annex III, Part 3, second subparagraph of Directive 2006/48/EC

275. The scope of the second subparagraph of Part 3 is limited to "contracts related to commodities other than gold". This does not include *exotic derivative*s. Consequently, the discretion provided by this subparagraph is not available for these contracts. We recommend to including *exotic derivative*s in the scope of this subparagraph to make this treatment available for *exotic derivative*s (the treatment is limited to firms which undertake significant commodities business, have diversified portfolios, and are not yet in a position to use internal models for calculating capital requirements).

3. The requirements for the use of internal models to calculate the capital requirements for commodities risk according to Annex V of the *CAD*, in particular in light of the shortcomings set out in Part C of the *second part of CEBS's technical advice*

276. Part C of the *second part of CEBS's technical advice* did not explicitly identify shortcomings in the use of internal models. It simply noted the following market practices:

"For the management of market risk firms employ methods with different levels of sophistication. A method for the assessment of market risk common to all markets is the use of value at risk models, though the sophistication of those models, probability level, data history used and other details vary between market participants. The effectiveness of such strategies depends on the appropriateness of the assessments and models...Most industry respondents use Value at Risk (VaR) models, including historic simulation, variance/covariance and Monte Carlo simulation, where expressed confidence intervals vary between 95-99% and holding periods between 120 days. Some firms conduct stress testing and some employ additional sensitivity measurement methods."

277. The Directive is silent on the model approval process, and competent authorities are therefore free to allocate resources to the approval process that are proportionate to the risk and size of the assessed firm.

Questions

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

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

II. CESR and CEBS views regarding different options

Commissions Questions

6) In view of the above and their initial advice, what are the views of CESR and CEBS with respect to the following options or combinations of options relating to the exemptions:

a) Issuing clarifying guidance as the meaning of the various exemptions and if so with what content;

b) Maintaining the current scope and nature of exemptions from the relevant *CAD* and *MiFID* requirements for the firms in the commodities sector: i.e. making the *CAD* exemption in Article 48(1) permanent and maintaining the *MiFID* exemption in Articles 2(1)(i) and (k) in place;

c) Studying the desirability of modifying the range of firms benefiting from exemptions and/or modifying the scope of exemptions to cover more or fewer of the different requirements of the *CAD* (i.e. capital requirements, large exposures, internal governance and risk management, disclosures etc.) or of the *MiFID* and to apply exemptions differently to certain commodities?

i) defining the criteria for determining when an activity is to be considered as ancillary to the main business on a group level as well as for determining when an activity is provided in an incidental manner (Article 2(3) of the *MiFID*);

ii) defining an appropriate regime for the prudential supervision of investment firms whose main business consists exclusively of the provision of investment services or activities in relation to commodity or *exotic derivative*s contracts (Article 48(2)(b) *CAD*);

iii) Create a further category of investment firms whose main business consist exclusively of the provision of investment services or activities in relation to the financial instruments in section C5, 6, 7, 9 and 10 of Annex 1 of the *MiFID* relating to *energy* supplies (Article 48(2)(b) *CAD*);

d) studying the desirability of making the existing exemptions optional for individual firms: i.e. firms in principle exempted that wanted the *MiFID* passport could opt-in to the European regime by accepting *MiFID* and *CAD* regulation; while firms which remained exempt would remain within any applicable national regimes

e) studying the desirability of making the existing or proposed exemptions mandatory: i.e. pre-empting Member States from regulating exempt firms under national rules relating to capital adequacy, organisational requirements and/or operating conditions;

f) removing some or all of the exemptions entirely?

1. Clarifying Guidance

278. CESR's October 2007 response to the Commission's request for initial assistance on *commodity derivative*s outlines the areas of consensus and disagreement regarding the practical application of the exemptions under Articles 2(1)(i) and (k) of the *MiFID* and Article 38 of the *MiFID* Implementing Regulation. (This information was provided in response to the Commission's question 9.)

- CESR reported that there is unanimous agreement that Article 2(1)(i) comprises two exceptions: one relating to dealing on own account and the other relating to providing services in *commodity derivative*s. But CESR also noted some questions on which interpretations differ: how the 'dealing on own account' exemption applies when a firm transacts with a client, and how it applies when the exemption covers all 'financial instruments'.
- Moreover, most Member States have their own interpretation of the terms 'clients of their main business', 'ancillary', and 'on a group basis', because they look to different sources to support the interpretation (i.e. company or accounting law in their jurisdiction).
- The exemption in Article 2(1)(k) of the *MiFID* appears less open to differences in interpretation, and most Member States will conduct a straight copy-out, with no need for additional guidance. Once again, 'part of a group' is the term most open to interpretation.
- The consensus view favours a case-by-case application of Article 38 of the *MiFID* Implementing Regulation, using the *MiFID's* definitions of regulated markets and *MTF*s.

279. Clarifying guidance complements any form of regulation, current as well as new. One issue that has been suggested for guidance is the exact meaning of the phrase "the provisions…shall not apply to investment firms whose main business consists exclusively of…" (provided that the exclusion in Article 48 *CAD* is maintained). One competent authority would advocate taking this provision literally: i.e. setting a threshold of 100% for the fraction of business that must consist of the provision of investment services or activities relating to commodities.

280. Finding an appropriate form for such guidance is a difficult task. CEBS guidance – because it is addressed to regulators, not to the industry – lacks

the legal certainty that the industry needs. And since the *CRD* is not a Lamfalussy Directive, implementing measures are not an option for the Commission. The most appropriate form – provided that the Directive is changed – is to amend the *CRD* text.

2. Retain the status quo / the status quo as maximum harmonisation

281. The market and regulatory failure analysis and other work undertaken thus far clearly indicate clearly that the option of maintaining the existing *CRD* and *MiFID* exemptions would not be responsive to the requirements of the industry and supervisors, and should not be adopted.

3. Desirability of modifying the range of firms benefiting from exemptions and/or modifying the scope of exemptions to cover more or fewer of the requirements of the *CAD* (capital requirements, large exposures, internal governance and risk management, disclosures, etc.) or the *MiFID,* and to apply exemptions differently to certain commodities

282. The market failure analysis did not find compelling evidence that the risks generated by *energy*-only investment firms differ materially from those posed by investment firms engaging in other *commodity derivative* activities/services. It therefore appears doubtful that there should be a separate class of *energy* investment firm subject to a regime that differs from the wider commodity regulatory regime.

29) Do you agree with the conclusion above?

4. Defining the criteria for determining when an activity is to be considered as ancillary to the main business on a group level as well as for determining when an activity is provided in an incidental manner

283. See Part C, Section II, number 4 above.

5. An appropriate prudential regime

284. As mentioned above, there is no obvious answer to what constitutes an appropriate prudential regime for *specialist commodities derivative firms*. The costs that would result from full application of the *CRD* to *specialist commodity derivative firms* might cause some of them to cease providing financial services/activities. An alternative would be to retain Article 48 of the *CAD*. However, as the market failure analysis in Part B concludes, *specialist commodities derivative firms* do generate some negative externalities – and

these externalities would be even greater important if the firms could passport commodity investment services across the EEA. The application of some prudential requirements would therefore appear justified, provided their benefits outweigh their costs. As mandated in the Commission's Call for Advice, we identify a range of prudential options "for further study in terms of likely impacts (costs and benefits)". It should be noted that none of the presented alternatives would eliminate the need for the adjustments for commodity products/markets set out in Part E, I, 1.

a. Option 1: no regulatory capital requirements but qualitative risk management

285. One option advocated by some sections of the industry would be an approach[71] founded on a 'risk control and disclosure framework'. As described by the industry, "the main features of this alternative approach are that:

1. the need for computing and holding regulatory capital is abandoned;
2. the approach leverages existing and proven risk management practices rather than simply copying what the banks do; and
3. the approach leverages off the disclosure requirements from accounting (IFRS) and develops requirements which are relevant to the commodity industry."

286. The qualitative risk management practices in the proposals appear to have merit, and serious consideration should be given to using them to underpin a qualitative prudential regime for commodities. For example, they list the standard range of prudential risks (market, credit, liquidity, and operational risk) and provide high-level guidance on how they should be managed and mitigated. They also allocate senior management and board responsibilities. And, as a final check, they attempt to exert market discipline by requiring disclosure of risk management practices and risk exposures.

287. Such a regime could be introduced by disapplying, or giving *specialist commodity derivative firms* the option to disapply, the Pillar 1 and large exposure requirements. Note that this would involve disapplying at least parts of Article 124 of Directive 2006/48/EC, which requires competent authorities to assess whether the capital held by *institutions* ensures sound management and coverage of their risks. Article 124 would not apply under a qualitative risk management approach, since according to paragraph 2 of Article 124 the scope of the review and evaluation of the risks to which *institutions* are or might be exposed shall be that of the requirements of this Directive, which includes the (Pillar 1) capital requirements and the large exposures regime. Such an approach would nevertheless allow such firms to use the European passport. However, *institutions* with exposures to firms that do not apply Pillar 1 requirements should not be able to benefit from the preferential credit or *CCR* treatment afforded to firms classified as 'institutions', because the assumption underlying this preferential treatment is that firms subject to full

[71] As proposed by the Commodity Firms Regulatory Capital Working Group (CFRC WG), a joint task force set up by ISDA, EFET and the FOA to discuss the prudential treatment of commodity firms in the EU.

prudential supervision, including Pillar 1 and large exposure requirements, pose less risk to counterparties.

288. Technically, such an approach could be implemented by providing an opt-out provision in Article 48 of the *CAD* and inserting a provision in Articles 79 and 86 of Directive 2006/48/EC that states that firms opting out cannot be treated as institutions in the Standardised and IRB approaches.

289. This option has some similarities to the Oil Market Participants (OMPs) regime that has been in operation in the United Kingdom for some twenty years, in that the OMP regime has no explicit capital requirements.

b. Option 2: Pillar 2-type approach

290. The approach described under option 1 may be enough to address the broad market confidence/integrity concerns generated by *specialist commodity derivative firms*. To the extent that such concerns persist, the Commission could consider strengthening the approach by requiring firms to calculate and hold regulatory capital. This could be as a natural extension of option 1, whereby firms would run through a qualitative checklist of risks and risk management/mitigation techniques and, based on their own judgments, estimate how much capital they need to cover residual risks. As in the current *CRD* Pillar 2 regime, this option could be subject to supervisory scrutiny and challenge. However, given the relatively low risk posed by *specialist commodity derivative firms* in practice, it is unlikely that supervisory intervention would be commonplace. (The United Kingdom financially regulates approximately 45 *specialist commodity derivative firms*; only three of them have an assigned permanent relationship-manager.

c. Option 3: Recalibrated *CRD*

291. The systemic risks posed by *specialist commodity derivative firms* might warrant the application of a *CRD*-type prudential regime, including Pillar 1 capital requirements. However, since these systemic concerns are limited (particularly relative to banks), it is worth exploring the options for a more proportionate regime. Options include:

(a) lowering Pillar 1 capital charges (for example, reducing the market risk 'outright' rate in the extended maturity ladder approach for electricity from 15% to 10%);

(b) making it less onerous for such firms to obtain model approval; and/or

(c) relaxing model requirements once model approval has been granted (for example, using a 95% confidence interval for VAR calculations instead of a 99% confidence interval).

292. Regarding option (b), we are of the view that the internal model approval requirements set out in Annex V of *CAD* are already flexible enough to permit competent authorities to apply requirements to *specialist commodity derivative firms* that are proportionate to the prudential risks that they pose.

d. Option 4: Full application of *CRD* to relevant *specialist commodity derivative firms*

293. While for credit institutions depositor protection is an additional aim of prudential regulation, prudential regulation generally aims at protecting investors (both clients and counterparts) and at ensuring the continuity of firms.[72] As a side-effect, prudential regulations are also expected to protect against market failures. All Member States are in agreement that the CRD is sufficient to achieve these aims, in particular as this paper suggests ways to resolve any weaknesses that the CRD may currently have with respect to the treatment of commodity business.

294. However, where the burden of applying the CRD outweighs the impact of a potential failure of a firm in light of the aims of prudential regulation, one could permit an opt-out from any prudential requirements for specialist commodity derivatives firms. In practice, an exemption could be justified where the impact of a default of an exempted firm on these prudential aims would be minor in terms of impact on clients, counterparts and market stability

295. Any specialist commodity derivative firm that would be exempted from the application of the CRD would not be treated as an institution according to Art. 3(1)c of the CAD. This implies in particular that when another institution has credit risk (including CCR) exposures outstanding with an exempted firm, it could not apply the preferential risk weights for exposures to institutions that are available under the standardised approach for credit risk.

296. The option as described above would see regulated specialist commodity derivative firms operating at a level of own funds commensurate with their risks as determined for all firms under the CRD. Accordingly, the likelihood of their default will be limited to what is accepted under the CRD with respect to the potential knock-effects on their creditors, counterparts, clients or the wider financial system. The prudential regime of the CRD, in particular the minimum capital requirements, provide protection against unanticipated losses that may occur even where sophisticated risk management techniques are applied, e.g. from a sudden default of a counterparty or a jump in market prices. This option avoids creating a competitive advantage of specialist commodity derivative firms over any credit institution or ISD investment firm engaged in the same business.[73] Finally, it does not require supervisors to run a separate prudential regime just for specialist commodity derivative firms.

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[72] Cf. Recital 12 of the *CAD*: „The own funds of investment firms or credit institutions (hereinafter referred to collectively as 'institutions') can serve to absorb losses which are not matched by a sufficient volume of profits, to ensure the continuity of institutions and to protect investors." This goes hand in hand with Recital 31 of the *MiFID*: "One of the objectives of this Directive is to protect investors. Measures to protect investors should be adapted to the particularities of each category of investors (retail, professional and counterparties)."

[73] Recital 12 of the *CAD*: "Furthermore, institutions, engage in direct competition with each other in the internal market. Therefore, in order to strengthen the Community financial system and to prevent distortions of competition, it is appropriate to lay down common basic standards for own funds."

Question

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

6. Complementary opt-in or opt-out regime

297. As a complement to options 1 to 3, the possibility for an opt-in or opt out regime in relation to the full *CRD* application for specialist *commodity derivatives* firms could be envisaged. The effects of an opt-in approach would in principle mirror the effects of an opt-out approach. For the sake of simplicity, only an opt-out approach is described below.

298. In our view, the preferential treatment granted by the *CRD* to the '*institutions*' exposure class should not be available for firms that are not subject to the full *CRD* rules, because this preferential treatment assumes that the firm is subject to full prudential supervision, including Pillar 1 and large exposure requirements.

299. The point of departure for an opt-out approach would be that *specialist commodity derivative firms* are subject to the full *CRD* application, but they could opt out of the full CRD in favour of whichever of the above options (option 1, 2, or 3) is ultimately selected by the Commission. In effect, *specialist commodity derivative firms* could choose between the preferential treatment for the '*institutions*' exposure class with the consequences of cheaper funding and better standing in the market (if they choose full *CRD* application), and less burdensome requirements (if they choose to opt out).

300. The concept of an opt-in or opt-out is not unknown to financial regulation. Precedents include Article 1, paragraph 3 of Directive 2003/71 (the Prospectus Directive). For the firm, the decision would involve weighing the benefits offered by lower capital requirements and better standing in the market against the higher cost of complying with the full regulatory regime. This would be purely a business decision for the firms. There would be no pressure to opt either way, and therefore the availability of the additional option can only be seen as beneficial for the firms. For supervisors, there is the consideration that supervision comes at a cost: i.e. in the resources of the supervisory authority. However, the authority should be able to recoup these costs from the firms through the fees that apply to all firms under regulation.

Question

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

Annexes

ANNEX I	Historical forward price approach

Insert into Directive 2006/49/EC, Annex IV

(d) Historical forward price approach

22. When determining the capital charges for other market risk positions, all contracts involving the same underlyings that are included in the institution's portfolio at the close of business on the current trading day shall be aggregated to form a single market risk portfolio (current market risk portfolio). Provided the institution does so on a consistent and permanent basis and with prior approval of the competent authorities, individual contracts contained in one market risk portfolio may be relocated and moved into another market risk portfolio if there is a verifiable hedging relationship between the contracts contained in this market risk portfolio and the market risks relating to this market risk portfolio. Approval shall be deemed to have been given if the institution applies for such merging informally and the competent authorities do not object within three months of the application being received. Any such application shall specify the type and scope of the business in the relevant market risk positions and shall also provide evidence of the hedging relationship. Applications for the following year shall be submitted to the competent authorities annually by the reporting date of 31 December and in the event of planned or actual deviations.

23. When determining the market value of the current market risk portfolio, the underlyings of all contracts in a current market risk portfolio, for options the delta equivalent, shall be disaggregated in such a way that none of the resulting underlyings forms a concrete part of one of the other resulting underlyings. For each individual underlying, the difference, with a positive or negative sign, between the rights and obligations shall be determined (net position). For each trading day during the observation period specific to the underlying the average market price for one unit of the individual underlying calculated for this day shall be multiplied by the absolute amount of the net position for this individual underlying (day market value of the net position).

The market value of the current market risk portfolio on one trading day shall be the sum of the absolute amounts of the market values of the net positions. The change in the market value of the current market risk portfolio for one trading day shall be the difference between the market value of this market risk portfolio on this and the preceding trading day. The accumulated change in market value over one trading day shall be the absolute amount of the sum of the changes in market value for this and the preceding nine trading days, provided that each of these trading days falls in the observation period, otherwise it is zero. For contracts denominated in foreign currency section 5 shall apply accordingly.

24. The competent authorities shall regularly announce the underlying-specific observation periods which are to be applied. If a position lacks an adequate price history, then the instrument's theoretical prices shall be determined.

25. The capital charge for each current market risk portfolio shall be calculated as the sum of the standard deviation of changes in market value of this market risk portfolio across all trading days in the underlying-specific observation period including the current trading day multiplied by a factor of 7.5 and the largest accumulated change in market value for one trading day during the observation period. The method of moments shall be applied to estimate the standard deviation. The total capital charge for other market risk positions shall be the sum of the capital charges for the current market risk portfolios.

26. The suitability of determining the theoretical market values of positions pursuant to point 24, second sentence shall be monitored through a verifiable daily back-test of estimated changes in value versus actual changes. The market value of each market risk portfolio shall be determined for those contracts contained in the institution's portfolio at the close of business on the previous trading day on the basis of the market prices calculated at the close of business on the current trading day in respect of one unit of the respective underlying in accordance with the procedure pursuant to section 2, and the difference shall be identified between this figure and the market value of this market risk portfolio calculated one day previously (change in value). In the event that this change in value is negative and if the absolute amount of this change in value exceeds the capital charge of the previous day divided by the square root of ten, the competent authorities shall be notified of this exception immediately and informed of its size and the reason for its occurrence.

27. Crisis scenarios adequate for the portfolio shall be conducted regularly, i.e. at least once a month. The institution shall verifiably and appropriately ensure

that its system of risk-reducing limits takes due account of the results of the crisis scenarios.