



Date: 18 January 2008
Ref: 08-064

CESR/CEBS CALL FOR EVIDENCE ON COMMODITIES

Background

In December 2007 the European Commission issued a Call for Technical Advice related to the review under Articles 65(3)(a), (b) and (d) of MiFID and Article 48(2) of the CRD. CESR and CEBS are requested to deliver its technical advice by end-July 2008 (see Annex).

CESR and CEBS are being asked jointly to give advice on certain issues concerning the regulatory treatment of firms that provide investment services in relation to commodity and exotic derivatives. In particular, the views of the committees are sought on whether the MIFID and CAD treatment of this type of firms continues to support the intended aims of market and prudential regulation.

In performing this work, the Call for Advice (CfA) suggests that CESR and CEBS analyse whether the present regulatory and market situation for providing investment services in relation to commodity and exotic derivatives gives rise to market failure, in particular by hampering the aims of market and prudential regulation. Furthermore, the CfA suggests that the committees analyse whether any different regulatory treatment of these types of firms across member states gives rise to regulatory failure by creating significant competitive distortions, significantly impairing the free movement of services and encouraging regulatory arbitrage.

CESR and CEBS are asked to consider if there are shortcomings in relation to commodities in the application of the CAD large exposures and free deliveries treatment, methods for the calculation of capital requirements and the obligation to uphold integrity of markets and conduct of business.

Furthermore, CESR and CEBS should set out, if the analysis of these issues varies in relation to the different types of entities providing investment services or the underlying financial instruments, in particular in relation to energy supply.

Finally CESR and CEBS are asked to provide advice on an appropriate regime for firms that provide investment services in relation to commodity and exotic derivatives, taking into account the different options presented in the CfA.

The CfA indicates that CESR and CEBS in their analysis should apply the framework for impact analysis recently drawn up by the 3 Level 3 Committees.

The treatment of commodities firms and commodities business has already been subject to two CfAs and one Call for Evidence (CfE) of the Commission. However, the former CfAs were primarily fact-finding exercises and the same is true for the CfE which provided a sounding board for industry concerns. At this time, CESR and CEBS are requested to give advice, which is a much more delicate issue since it might imply choices potentially affecting the scope of the current regulatory regime.

Call for evidence

CESR and CEBS are inviting all interested parties to submit their views regarding the CfA and especially in relation to the questions contained in its annex.

CESR and CEBS would like to point that the purpose of their work is not to duplicate the work of the Commission. Therefore there is no need to re-submit those which were sent to the Commission.

All contributions can be submitted online via CESR's website under the heading Consultations at www.cesr.eu by **18 February 2008**. All contributions received will be published on the CESR and CEBS websites unless specifically requested otherwise.

Annex



EUROPEAN COMMISSION
Internal Market and Services DG

Director-General

Brussels, 21.12.2007
MARKT G3/HH/cr D(2007)

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Subject: Request for joint CESR/CEBS advice on commodity derivatives

Dear Danièle, Dear Eddy

Many thanks for the very helpful initial advice provided by CESR and CEBS with regards to the Commission's work under Article 65(3) of the MiFID and Article 48(2) of the CAD. Further to this, I enclose a joint mandate for advice on a range of further topics.

You will note that we anticipate receiving the joint advice from CESR and CEBS by the end of July 2008.

Note also that another stream of work is forthcoming the review of record-keeping and market transparency under the Third Energy Package will be dealt with under a separate mandate to CESR and ERGEG, including an assessment of the scope of the Market Abuse Directive as regards commodity markets.

Yours sincerely,

[signed] Jörgen HOLMQUIST

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Mandate to CESR and CEBS for technical advice

Review under Articles 65(3)(a), (b) and (d) of MiFID and 48(2) of CAD

This mandate requests joint advice from CESR and CEBS on certain issues concerning revision of the provisions of Directive 2004/39/EC (MiFID) and Directive 2006/49/EC (CAD) concerning the regulatory treatment of firms that provide investment services in relation to commodity and exotic derivatives.

This mandate is given in order to ensure that the Commission has adequate technical background to be able to complete its report under Article 65(3)(a), (b) and (d) of Directive 2004/39/EC and Article 48(2) of Directive 2006/49/EC (the Report).

The present mandate takes into full consideration the agreement on implementing the Lamfalussy recommendations reached with the European Parliament on 5 February 2002. In this agreement, the Commission committed itself to a number of important points, including full transparency. For this reason, this request for technical advice will be published on DG Internal Market's web site and the European Parliament duly informed.

1. BACKGROUND AND LEGAL FRAMEWORK

The European Commission is to report to the European Parliament and the Council on the following:

Article 65(3) of MiFID relevantly requires the Commission to report on:

- (a) the continued appropriateness of the exemption provided for in Article 2(1)(k) for undertakings whose main business is dealing on own account in commodity derivatives;
- (b) the content and form of proportionate requirements for the authorisation and supervision of such undertakings as investment firms within the meaning of this Directive; ...
- (d) the continued appropriateness of the exemption provided for in Article 2(1)(i).

Article 48 of CAD relevantly states:

2. As part of the review required by Article 65(3) of Directive 2004/39/EC, the Commission shall, on the basis of public consultations and in the light of discussions with the competent authorities, report to the Parliament and the Council on:

- (a) 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 the commodity derivatives or derivatives contracts set out in points 5, 6, 7, 9 and 10 of Section C of Annex I to Directive 2004/39/EC; and
- (b) the desirability of amending Directive 2004/39/EC to create a further category of investment firm whose main business consists exclusively of the provision of investment services or activities in relation to the financial instruments set out in points 5, 6, 7, 9 and 10 of Section C of Annex I to Directive 2004/39/EC relating to energy supplies (including electricity, coal, gas and oil).

3. On the basis of the report referred to in paragraph 2, the Commission may submit proposals for amendments to this Directive and to Directive 2006/48/EC and 2006/49/EC.

The purpose of this mandate is to seek technical advice in order to provide foundations for the Commission's work on the Report.

2. CONSULTATION AND SOURCES OF ADVICE

The Commission is to act 'on the basis of public consultation and in the light of discussions with competent authorities'. The Commission's White Paper on Financial Services Policy 2005-2010 set out our commitment to open and transparent consultation:¹

Open consultations (including with stakeholder groups) will continue to play a central role and will be required before any legislation is deemed necessary. The Commission will continue to publish responses received to its consultations, practical summaries and feedback statements.

In fulfilment of this commitment, we published a Call for Evidence on 8 December 2006, which was open until 30 April 2007. A statement summarising the feedback, published on 14 August 2007, is available on our website.² CESR and CEBS are asked to consider the views expressed in this consultation and the conclusions reached in the feedback statement.

Separate mandates for initial advice were issued on 13 March 2007 to CESR and on 16 August 2006 to CEBS, both in two parts. Both sets of initial advice have now been received and studied by the Commission.

3. THE PRINCIPLES TO WHICH CESR AND CEBS SHOULD HAVE REGARD

As regards its working approach, CESR and CEBS are invited to take account of following principles:

- The principles set out in the Lamfalussy Report and mentioned in the Stockholm Resolution of 23 March 2001;
- CESR and CEBS should provide comprehensive advice on the matters described in Annex I;
- CESR and CEBS should address to the Commission any questions which arise in the course of its work;
- Where appropriate, CESR and CEBS should rely on conclusions in the initial advice they have rendered the Commission as well as the results of the Commission's own consultations to date, so as to minimise to the extent possible re-consultation on the same topics.

4. QUESTIONS IN RELATION TO WHICH TECHNICAL ADVICE IS SOUGHT

Please consult **Annex I** for a list of questions in relation to which advice is sought.

¹ *Op. cit.* at paragraph 2.1.

² http://ec.europa.eu/internal_market/securities/docs/isd/derivatives_en.pdf

5. DUE DATE

The advice from CESR and CEBS is sought by **the end of July 2008**.

Annex I

Questions on which technical advice is sought

We propose the following definitions:

- Relevant markets: the market(s) in the EEA for commodities, commodity derivatives, and exotic derivatives.

- Energy derivative: a commodity derivative or exotic derivative relating to energy supplies (including electricity, coal, gas and oil).

- Market failure: any significant sub-optimality in market functioning. For example, where applicable, evidence of this could take the form of a wide dispersion of market prices, persistent concentrated market shares, persistent excess profits, a high level of investor complaints, significant information asymmetries leading to mis-allocation of resources, excessive risk-taking leading to a potentially high level of systemic risk, etc.

For the definitions of commodity and exotic derivatives, the relevant definitions in MiFID apply.

Analysis

Based on their initial advice, CESR and CEBS are invited to answer the following:

- 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?
- 2) Do the differences in regulatory treatment between categories of firms that provide investment services in relation to commodity and exotic derivatives 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?

Technical recommendations

- 4) Based on the response to questions 1 to 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 continue 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 CEBS' second advice ?
 - b) the method for calculating capital requirements for commodities risk set out in Annex IV of Directive 2006/49/EC in particular, in light of the shortcomings set out in Part C of CEBS' second 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/EC in particular, in light of the shortcomings set out in Part C of CEBS' second advice?
 - 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 financial 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);
- 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?
- 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 CAD (i.e. capital requirements, large exposures, internal governance and risk management, disclosures etc.) or 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) 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 derivatives contracts (Article 48(2)(a) CAD);
- iii) 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 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?

Impact analysis

CESR and CEBS should analyse the options that they identify 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.

To the extent possible, in developing their advice CESR and CEBS should apply the framework for impact analysis recently drawn up by the 3 Level 3 Committees.

Wherever possible, quantitative and statistical data and economic analysis should be provided to justify conclusions.