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**CESR/CEBS's 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<sup>1</sup>. 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 of categories of firms that provide investment services relating to *commodity derivatives*, or between 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* treatments of firms providing investment services relating to *commodity derivatives* 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

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<sup>1</sup> The reports are published at [http://www.c-eps.org/press/documents/CO\\_%20Supervisory%20survey.pdf](http://www.c-eps.org/press/documents/CO_%20Supervisory%20survey.pdf), <http://www.c-eps.org/Advice/documents/Commoditiesriskassessment10102007.pdf>, [http://www.cesr-eu.org/index.php?page=document\\_details&from\\_title=Documents&id=4821](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 the various options and combinations of options relating to the exemptions set out in *MiFID* and *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 *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 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/CEBS created a Joint Task Force on Commodities (ComTF) to prepare their response to the Joint Call for Advice.
6. The findings and recommendations of this report build to a large extent on the technical advice already provided to the Commission by CESR and CEBS. They 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/CEBS published their own Call for Evidence on 18 January 2008. CESR/CEBS received six responses. Two respondents requested confidential treatment of their responses. The other responses<sup>2</sup> 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 the 3L3 framework for impact analysis.
9. The preliminary findings and conclusions drawn from the market and regulatory failure analyses have been published in a Consultation Paper (CP 3L3 08 02). The purpose of the public consultation was to gather industry feedback on the likely impact of the options for a possible future prudential regime for *commodity derivatives markets* and to obtain further information on specific issues. CESR/CEBS have received 16 responses on the Consultation Paper. Three respondents have requested confidential treatment. The other responses have been published on the CESR and CEBS websites at <http://www.cesr.eu/index.php?page=responses&id=111> and [http://www.c-eb.org/Consultation\\_papers/CP3L30802\\_responses.htm](http://www.c-eb.org/Consultation_papers/CP3L30802_responses.htm).

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<sup>2</sup> ISDA/FOA/EFET, German Banking Association, Danish Shareholders Association, BDEW

10. In addition, further industry input has been obtained from two public hearings on 7 July and 4 September 2008.

## Executive summary

11. Part A gives a short overview of recent developments in *commodities markets*.

12. Part B of the technical advice looks at possible market failures in *commodity derivatives markets* to provide a framework for the subsequent discussion of policy issues. It focuses on potential market failures linked to asymmetric information and negative externalities. Key points made include:

- the majority of participants in the *commodity derivatives markets* are *sophisticated* clients and, outside of the limited direct participation in these markets by private clients, the potential for significant information asymmetries is limited - however, participants which are active in both the *commodity derivatives markets* and *commodity* production or supply may have informational advantages;
- low levels of transparency in *OTC commodity derivatives markets* give rise to potential concerns. In practice, regulated trading firms have not raised this as an issue which deters them from participating in the markets;
- *commodity derivative markets*, like other financial markets, are subject to informational asymmetries which can and sometimes do lead to abusive market conduct; and
- the activities of *specialist commodity derivatives firms* can give rise to systemic risks through externalities. CESR/CEBS are of the view that the systemic risks generated by these firms appear in general to be lower than the systemic risks and externalities generated by credit institutions and *ISD investment firms*.<sup>3</sup>

13. Part C of the paper discusses potential regulatory failures related to firms that provide investment services in *commodity derivatives markets* and whether potential regulatory failures lead to competitive distortions:

- CESR/CEBS believe that the application of the *CRD* requirements (including the large exposures regime) to *specialist commodity derivatives firms* would be disproportionate and would lead to regulatory failure<sup>4</sup> - industry responses to the Consultation Paper state invariably that they believe full application of *CRD* would be disproportionate;
- There may also be issues with the current client categorisation rules and transaction reporting requirements as these may not be sufficiently adapted to the *commodity derivatives markets*;
- Another area which may give rise to competitive distortions is existing regulatory differences across the EU which may also lead to the potential for regulatory arbitrage; and

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<sup>3</sup> BaFin, Commission Bancaire and Bank of Slovenia question whether this is generally true.

<sup>4</sup> BaFin, Commission Bancaire and Bank of Slovenia do not share this view.

- CESR/CEBS are of the opinion that to the degree that market and regulatory failures have been identified it is unlikely that the market will be able to correct these in the short to medium term.

14. Part D of the advice deals with two main issues:

- first, whether *MiFID* rules (relating to pre-trade and post-trade transparency, organisational requirements, conduct of business rules, and client categorisation, etc.) should be adapted for *commodity derivatives* business; and
- second, where the boundaries of *MiFID* should be set with respect to *commodity derivative* contracts and firms providing investment services/activities relating to *commodity derivatives*.

15. In respect of *MiFID* rules the main conclusions of CESR/CEBS<sup>5</sup> are:

- there is not much benefit to be gained by mandating through legislation greater pre- and post-trade transparency in *commodity derivatives markets*;
- the obligation on investment firms to send transaction reports in respect of transactions involving *commodity derivatives* to competent authorities under Article 25(3) of *MiFID* should be maintained but for the practical implementation of this requirement, it would be sufficient to continue with the current practice where regulated markets report trading in *commodity derivatives* on their markets to the local regulator;
- there is no need to change either the organisational requirements or conduct of business rules in *MiFID* for *commodity derivatives* business; and
- investment firms should be allowed to treat clients (other than individuals) on request as professionals when providing services in relation to *commodity derivatives* on the basis of the criteria in the first four paragraphs of section II.1 of Annex II of *MiFID* (i.e. clients should not necessarily have to meet two of the three criteria relating to the frequency of their trading, the size of their portfolio and working in the financial sector).

16. In respect of the boundaries of *MiFID* the main conclusions of CESR/CEBS are:

- the definition of *commodity derivatives* generally works well and does not need to be amended;
- there is a case for revising the exemptions in Articles 2(1)(i) and (k) of *MiFID* to provide a very narrow exemption for the incidental provision of investment services related to *commodity derivatives* and an exemption for primarily non-financial firms which trade on own account with *sophisticated* clients;
- the best route to greater certainty and more consistent interpretation of the exemptions is wide agreement about the purpose of the exemptions which is then transformed into clear language in legislation; and
- the Commission should consider whether an additional Article could be included into *MiFID* which would clarify that firms covered by the exemptions relating to commodity derivatives in Article 2 shall not be prevented from being authorised as investment firms.

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<sup>5</sup> The Autorité des Marchés Financiers (AMF) does not share the conclusion on transparency.

17. Part E of the advice deals with whether the regulatory regime should differ depending on the type of entity providing the investment services or the underlying of the financial instrument. CESR/CEBS's main conclusions on this question (which do not cover the issues being dealt with in CESR/ERGEG's work) are:
- it is not appropriate to differentiate the regulatory regime based on the underlying *commodity*, asset, right, service or obligation; and
  - there is no compelling evidence to suggest that the risks generated by *energy-only* investment firms differ materially from those posed by investment firms engaging in other *commodity derivative* activities/services.
18. Part F of the advice deals with the Commission's questions relating to the treatment of *specialist commodity derivatives 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.
19. Firstly, Part F discusses the application of the *CRD*'s large exposures regime to *specialist commodity derivatives firms*. It is concluded that the full application of large exposure rules would, given current usages in *commodities markets*, demand very significant amounts of own funds for *specialist commodity derivatives firms*. CESR/CEBS conclude that the application of the *CRD* large exposures regime to *specialist commodity derivatives firms* appears disproportionate, and that it would appear appropriate to adopt an approach comparable to that of Article 45 *CAD*.<sup>6</sup>
20. Secondly, it discusses the maturity ladder approach and why it appears to be unsuitable for *commodities*. CESR/CEBS suggest providing two alternative approaches as an option for institutions, one using the current forward price and the other deriving forward prices from the history of forward prices over a specified observation period.
21. Thirdly, CESR/CEBS propose giving credit institutions with ancillary agricultural commodities business the possibility of determining once a year their regulatory capital requirements for their *commodity* risk. Furthermore, some other shortcomings in *CRD* are addressed.
22. Finally, Part F proposes two different options for the prudential treatment of *specialist commodity derivatives firms*. One option would require *specialist commodity derivatives firms* to meet a high-level requirement to have adequate financial resources and qualitative risk management requirements. The second option proposes the full application of *CRD* to *specialist commodity derivatives firms* with the possibility of an opt-out from any prudential requirements for firms where this would not impede the overall aims of prudential regulation.

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<sup>6</sup> BaFin, Commission Bancaire and Bank of Slovenia do not share this view.



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## Glossary

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

<i>CAD</i>	Capital Adequacy Directive (Directive 2006/49/EC)
<i>Cash market</i>	Within each market for a type of underlying, the <i>cash market</i> is limited to spot contracts in the sense of Article 38(2)(a) of Commission Regulation 1287/2006
<i>CCR</i>	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 <i>CCR</i> 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 <i>CAD</i> )
<i>Commodity derivatives markets</i>	Markets for <i>commodity derivatives</i> (if the market for a specific product is referred to the product is mentioned)
<i>Commodity</i>	Any goods of a fungible nature that can be delivered, including metals and their ores and alloys, agricultural products, and <i>energy</i> such as electricity (according to Article 2 paragraph 1 of the Commission Regulation 1287/2006 ( <i>MiFID</i> Implementing Regulation))
<i>Commodity markets</i>	Markets for physical commodities and <i>commodity derivatives</i> (if the market for a specific product is referred to the product is mentioned)
<i>Commodity derivatives</i>	Financial instruments listed in Annex I, Section C(5) to (7) of <i>MiFID</i> . Unless otherwise indicated, any reference to <i>commodity derivative(s)</i> in this document also includes 'exotic' derivatives.
<i>CRD</i>	The Capital Requirements Directive (Directive 2006/48/EC and Directive 2006/49/EC)
<i>Energy</i>	Oil, gas, coal, electricity and biofuel
<i>Exotic derivatives</i>	Financial instruments listed in Annex I, Section C(10) of <i>MiFID</i> (including derivatives with climate variables, freight rates, emission allowances or inflation rates, or other official

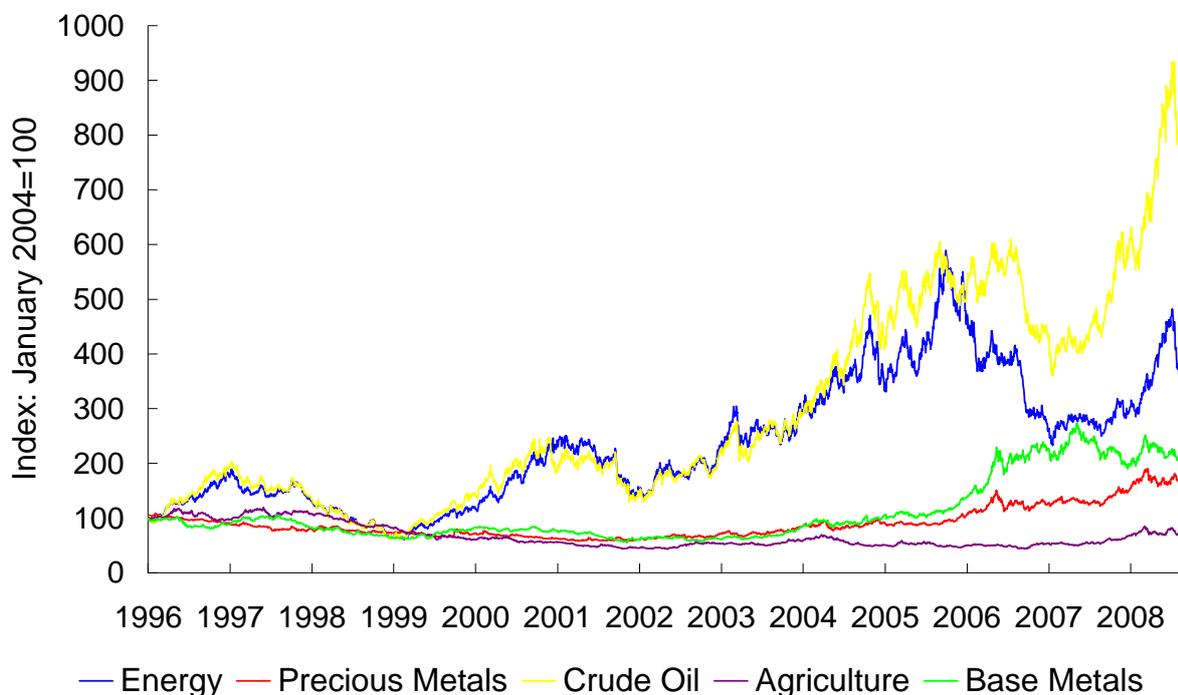
	economic statistics as the underlying)
<i>Forward transaction</i>	A contract that includes an obligation of at least one of the counterparties which has a due date which is later than that for spot contracts in the sense of Article 38(2)(a) of the Commission Regulation 1287/2006
<i>Futures</i>	Standardised forward transactions that are traded on an exchange
<i>Institutions</i>	Credit institutions and investment firms as defined in <i>CRD</i> and <i>MiFID</i>
<i>ISD</i>	The Investment Services Directive (Directive 93/22/EEC)
<i>ISD investment firm</i>	Investment firms covered by the scope of the <i>ISD</i>
<i>MiFID</i>	Markets in Financial Instruments Directive (2004/39/EC)
<i>MiFID Implementing Regulation</i>	Commission Regulation (EC) 1287/2006 of 10 August 2006
<i>MTF</i>	A Multilateral Trading Facility as defined in Article 4 (15) of <i>MiFID</i>
<i>OTC</i>	Over the counter (i.e. any transaction conducted outside a regulated market or <i>MTF</i> )
<i>Physical position</i>	A transaction settled in physical form (i.e. by delivering the underlying)
<i>Second part of CEBS's technical advice</i>	The CEBS commodities prudential risk report published at <a href="http://www.cebs.org/Advice/documents/Commoditiesriskassessment10102007.pdf">http://www.cebs.org/Advice/documents/Commoditiesriskassessment10102007.pdf</a>
<i>"Sophisticated" client/market participants</i>	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.
<i>Specialist commodity derivatives firm(s)</i>	Firms that restrict their <i>MiFID</i> 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

1. Descriptions of the *commodity derivatives markets* in the EU are available from a variety of sources. These include the CEBS's 2007 technical advice for the Commission<sup>7</sup>, the CESR/CEBS Consultation Paper in response to the current request for advice from the Commission<sup>8</sup> and the 2008 report of the European Securities Markets Expert Group<sup>9</sup>. This report does not attempt to add to the material provided in these sources.
2. Since the Commission sent its request for advice to CESR/CEBS at the end of 2007 developments in *commodity* and *commodity derivatives markets* have assumed greater significance. *Commodity* prices have, on average, fallen in real terms over the past 50 years. However, there have been at times spikes in prices. In recent years prices have risen sharply, starting with non-food *commodities* and more recently food.

### Movement in commodity futures prices



<sup>7</sup> <http://www.c-eps.org/Advice/documents/Commoditiesriskassessment10102007.pdf>,

<sup>8</sup> [http://www.c-eps.org/Consultation\\_papers/consultationpapers.htm](http://www.c-eps.org/Consultation_papers/consultationpapers.htm)

<sup>9</sup> [http://ec.europa.eu/internal\\_market/securities/esme/index\\_en.htm](http://ec.europa.eu/internal_market/securities/esme/index_en.htm)

3. The recent rises in *commodity* prices appear to have been driven, at least in part, by strong demand growth and supply problems. There has been discussion of the role that increased participation by financial investors in *commodity derivatives markets* and speculation have played in recent price rises. Some sources have suggested that speculation has played a significant role in raising *commodity* prices<sup>10</sup> but other sources<sup>11</sup> have not found a strong link between the behaviour of financial investors and changes in the prices of *commodity derivatives*.
4. The rise in *commodity* prices has stimulated debate about *commodity* and *commodity derivatives markets* in the EU and beyond. For example, the European Council Conclusions in June 2008<sup>12</sup> dealt with the policy consequences of high food and oil prices. Amongst other things they asked the Commission to monitor developments in *commodity markets* and report back to the December 2008 European Council. In the US various House and Senate committees have held hearings on issues related to *commodity derivatives markets*.
5. The Commission's Call for Advice did not ask for a view on developments in *commodity markets* or regulation in third countries. However, in preparing this advice CESR/CEBS have been conscious of developments in the wider environment that might have relevance for their work. This advice on the EU's regulatory framework for *commodity derivatives* is intended to ensure that the framework supports the achievement of regulatory objectives and promotes the competitiveness of the EU as a location for the trading of *commodity derivatives*.

## Part B. Market failure analysis<sup>13</sup>

### 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? "

6. Market failure is defined in the Call for Advice as "any significant sub-optimality in market functioning". CESR/CEBS have focussed on what they consider to be the main areas of potential market failure in the area of *commodity derivatives markets*: negative externalities (which are addressed

<sup>10</sup> For example [http://hsgac.senate.gov/public\\_files/SenatePrint10965MarketSpecReportFINAL.pdf](http://hsgac.senate.gov/public_files/SenatePrint10965MarketSpecReportFINAL.pdf)

<sup>11</sup> For example [www.cftc.gov/stellent/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf](http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf) and [www.farmlandoc.uiuc.edu/marketing/morr/morr\\_08-02/morr\\_08-02.pdf](http://www.farmlandoc.uiuc.edu/marketing/morr/morr_08-02/morr_08-02.pdf)

<sup>12</sup> [www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ec/101346.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/101346.pdf)

<sup>13</sup> This section does not prejudge the outcome of the market failure analysis that will be conducted in the CESR-EREG context.

by prudential regulation) and information asymmetries (which are addressed by market regulation)<sup>14</sup>.

7. Five respondents to CESR/CEBS's 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.

## **I. Hampering of the aims of market regulation<sup>15</sup> through information asymmetries**

8. 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 to 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.
9. The magnitude of information gaps in the *commodity derivatives* sector varies according to the relative differences in knowledge and experience between transacting parties. In general, the information gap increases as one moves 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;
  - c) financial institutions active in *commodity derivatives markets* but not in the underlying physical markets;
  - d) corporate purchasers of *commodity derivatives* for hedging or investment purposes; and
  - 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**

10. 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.
11. As explained in the descriptions of EU *commodity derivatives markets* mentioned in previous Advices, there is a low level of direct investment by

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<sup>14</sup> 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.

<sup>15</sup> Market regulation is taken to include conduct of business rules, client asset rules, conflict management requirements, transaction and transparency obligations and anti-market abuse rules (and the organisational requirements to ensure that firms comply with market regulation).

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 derivatives* 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:

1. provided by regulated brokers and credit institutions, and hence clients receive the benefits of *MiFID* protection<sup>16</sup>; and
  2. in general not provided by *specialist commodity derivatives firms* directly to unsophisticated private clients.
12. Nevertheless, some types of unsophisticated corporate clients participate directly in *commodity derivatives markets*. This is generally limited to producers and wholesale distributors of commodities. While these firms may be experienced in trading in physical *commodity markets*, they may lack sufficient experience and knowledge of derivatives markets and hence mis-selling risks arise.
13. The responses to the Consultation Paper made a number of points about the nature of clients active in *commodity derivatives markets*. One respondent said that private clients are increasing their direct and indirect participation in *commodity derivatives markets* through vehicles such as warrants, certificates and collective investment schemes. Other respondents emphasised that most clients active in the physical markets should be regarded as *sophisticated clients* because using financial markets is an integral part of their commercial activities.
14. The responses to the Consultation Paper expressed some concern about information asymmetries linked to data about developments in physical *commodity markets* such as, for example, outages at power plants. However, one respondent said that there are many sources of information that are commercially available to market participants and that the sophistication of most market participants meant that they were well able to take into account possible information asymmetries.
15. Most respondents thought that information asymmetries in *commodity derivatives markets* did not lead to mis-selling concerns. However, one respondent representing firms other than *specialist commodity derivatives firms* said that information asymmetries linked to developments in the physical market could put the clients of their members at a disadvantage relative to market participants active in the physical market.

## Conclusion

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<sup>16</sup> FSA, 2007: Growth in commodity investment: risks and challenges for commodity market participants, March 2007

16. The vast majority of participants in the *commodity derivatives markets* are either firms (both financial firms and commercial firms which produce, distribute or consume commodities) or public bodies. Many, but not all of these participants are *sophisticated* and have the knowledge and experience to make their own investment decisions. Information asymmetries between investment firms and *sophisticated* clients are relatively small. There are likely to be greater information asymmetries when unsophisticated clients are involved. Their direct participation in the sector is currently mainly limited to some firms and public bodies having knowledge and experience in physical commodities markets but not of trading in *commodity derivatives markets*. Outside the limited direct participation in *commodity markets* by private clients the potential therefore for significant market failures due to information asymmetries is therefore limited.
17. 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).

## **2. Information Asymmetries and Market Transparency<sup>17</sup>**

18. 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).
19. 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). The derivatives and physical markets are discussed separately below. However, the *second part of CEBS's technical advice* highlighted how financial and commodities markets overlap, are interrelated and influence one another. It describes the links in pricing between *commodity derivatives* and spot markets taking into account the specificities of storable and non-storable commodities. On a more general level, the collapse of Amaranth and the resulting increase in volatility in world-wide stock exchanges illustrated 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

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<sup>17</sup> Market transparency issues in this section refer to pre and post trade price and volume information

increase liquidity needed to meet margin calls in other financial markets; conversely others are reportedly increasing investment in commodities and *commodity derivatives* as a refuge from wider financial turmoil and as an inflation hedge.

#### **a. Derivative markets**

20. In the shorter-term, the more commoditised end of the derivatives markets' business is often conducted on exchanges and transparency standards are therefore high. Trading on *MTFs* is also generally transparent. Market data are also available from commercial data services such as Bloomberg and Reuters.
21. 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 by market participants about a lack of transparency can be a sign of a market failure.

#### **b. Physical markets**

22. 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 derivatives* to optimise their business. For example, in Norway, two thirds of *commodity derivative* trades are completed by firms that also trade in the underlying commodities on *cash markets*. In the United Kingdom, approximately 60% of FSA-authorized firms engaging in *commodity derivative* investment activities also have commercial operations in the underlying physical market.
23. Organisations with commercial operations in the physical markets clearly have an information advantage over other participants in the derivatives markets. 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 participants 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.
24. Some market participants view the informational advantage of those active in the physical market 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

25. 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 on obtaining, for example because the costs are substantial as in the case of Genscape and information that is not in the public domain. The latter gives rise to 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.
26. 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.
27. The responses to CESR/CEBS's Consultation Paper on transparency in *commodity derivatives markets* were mixed. Some respondents said that they believed there was an adequate level of transparency in the market already. One respondent suggested that further regulation in this area would be inefficient and deter firms from freely hedging risk. However, one respondent thought there was a need to organise the regular publication of core data on the physical market and that it would be worthwhile to publish price and volume data on completed *OTC* trades (but did not believe that further requirements in relation to pre-trade transparency would be helpful). Another respondent suggested that *MTFs* should have the same transparency requirements as regulated markets.

## Conclusion

28. 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.

## 3. Information asymmetries and market abuse

29. 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.

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<sup>18</sup> Cf. certain EEX press releases, e.g. as of 21 May 2007.

30. 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 them and the market in the underlying *commodity* that give rise to market abuse concerns.
31. 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 their underlying *commodity* production and supply activities. Derivatives trading based on knowledge of their production and supply activities should not generally be regarded as an inappropriate use of information unless that information is expected to be publicly available. These issues are reflected in the separate definition of inside information for *commodity derivatives* in the Market Abuse Directive.
32. 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.
33. 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*.
34. There have been some recent high profile cases alleging market abuse in *commodity derivatives markets*. 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 with the objective of dictating prices to other market participants in order to obtain a significant trading profit.
35. 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 advantage. For instance, the value of an option with a forward as the 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.

36. Responses to the Consultation Paper pointed out that *commodity derivatives* are already within the scope of the Market Abuse Directive. One respondent referred to efforts to corner or squeeze markets citing wheat trading on the Minneapolis Grain Exchange in the first quarter of 2008 as an example of this.

## Conclusion

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

## II. Hampering of the aims of prudential regulation<sup>19</sup> through negative externalities

38. 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).
39. 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 have historically 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 have systemic consequences. When examining systemic risks generated by *commodity derivatives* 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 can be contrasted with the size of other financial markets and with the level of exposures between the two.

### 1. Impact on Financial Markets

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<sup>19</sup> 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.

40. 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:

1. credit risk exposures – through credit institutions' lending and providing collateral and guarantees to *commodity market* participants;
2. credit risk exposures – through *CCR* exposures; and
3. 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.

41. 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."

42. 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 *CCR* to market participants, including to *specialist commodity derivatives firms*. CESR/CEBS think that both forms tend to be of a lower order between *specialist commodity derivatives firms* and *institutions*, when compared to the interconnections between *institutions* themselves.<sup>20</sup> Credit risk and *CCR* exposures arising from lending by credit institutions to *specialist commodity derivatives firms* can be assessed in the same way as exposures to other types of clients of credit institutions.

43. 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 can have an impact on *ISD investment firms* or credit institutions that have invested in these markets.

44. Trading interconnections are relatively limited because the share of the commodities business of *institutions* in relation to total trading is relatively small. For example, the total outstanding notional value of *OTC* contracts in the G10 countries and Switzerland is estimated at \$516 trillion, of which \$7.5 trillion (1.5%) is in commodities<sup>21</sup>. The vast majority of derivatives trading involves *institutions* trading contracts whose underlying is an interest rate,

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<sup>20</sup> BaFin, Commission Bancaire and Bank of Slovenia believe that it is not possible to distinguish between the systemic risk posed by *specialist commodity derivatives firms* and institutions because the attempt to do so assumes that: any institution is active in more markets than *specialist commodity derivatives firms*, the risk of lending exposures is different from lending to a "normal" undertaking which generates returns by "normal" production activities and the business activities of such "normal" undertakings typically do not involve the same level of market risk and *CCR* that a *specialist commodity derivative firm* is exposed to.

<sup>21</sup> Bank of International Settlements: Semi-annual *OTC* derivatives statistics at end-June 2007.

equity, debt, or foreign exchange product, although some of the consequential *CCR* exposures are to *specialist commodity derivatives firms*.

45. This does not mean, however, that *institutions* could not be exposed to significant losses in these markets, since high volatility in commodities markets can lead to market price or spread changes, resulting in losses that are high relative to their participation in these markets. In addition, interconnections between *specialist commodity derivatives 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* could also have *CCR* exposures to *specialist commodity derivatives firms* in other types of instruments such as interest rate and foreign exchange derivatives.
46. *Specialist commodity derivatives firms* occupy a different position within the financial system compared to (other) *institutions* and CESR/CEBS believe this difference has systemic risk implications because they believe it has an effect on the consequences of the failure of a *specialist commodity derivatives firm*. In addition to trading on their own account, *specialist commodity derivatives 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*<sup>22</sup>.
47. In contrast, credit institutions 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 derivatives firms* do not perform these functions, they do not raise the related concerns.
48. The negative externalities associated with *ISD investment firms* are different from those arising from *specialist commodity derivatives firms*. Most *ISD 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<sup>23</sup>.
49. 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. CESR/CEBS are of the opinion that the result is that, in general, the failure of an *ISD investment firm*

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<sup>22</sup> BIS Quarterly Review, March 2007

<sup>23</sup> See De Bandt, O. and P. Hartman (2000), "Systemic Risk: a Survey", ECB Working Paper 35, European Central Bank

is likely to have systemic implications greater than those generated by the failure of a comparable *specialist commodity derivatives firm*.<sup>24</sup>

50. So far there have been no cases in which interconnections between *specialist commodity derivatives 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* may alter the risk landscape.

## 2. Impact on Commodities Markets

51. Some *specialist commodity derivatives 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 *energy* markets.<sup>25</sup>

52. 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.

53. 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.

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<sup>24</sup> BaFin, Commission Bancaire and Bank of Slovenia are of the view that a general distinction cannot be drawn between *specialist commodity derivatives firms* and *ISD investment firms* with respect to systemic risk but that the failure of certain individual *specialist commodity derivatives firms* may have potential systemic implications similar to the failure of *ISD investment firms*. These members refer to their observation that the negative externalities of *specialist commodity derivatives firms* are indirect rather than direct, which makes it hard to compare their negative externalities with the negative externalities caused by *ISD investment firms*.

<sup>25</sup> BaFin, Commission Bancaire and Bank of Slovenia conclude from this that the impact of failures of *specialist commodity derivatives firms* on market prices and spreads could result in indirect negative externalities comparable to those caused by other *ISD investment firms*, both with respect to activities of *ISD investment firms* in commodities markets as well as in other (financial) markets and believe that this holds true especially where the contagion of the wider financial system occurs via indirect interconnections, i.e. via impacts on market prices and spreads in commodities markets in which *ISD investment firms* and credit institutions have invested.

54. 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*<sup>26</sup>. A sharp raise in prices was also observed in the German electricity market following the failure of Enron.
55. Respondents to the Consultation Paper said that they thought the systemic risks posed by *specialist commodity derivatives firms* were low particularly as against those posed by banks. One respondent, however, suggested that there may be some specific risks for *energy firms*.

## Conclusion

56. Although connections do exist between *specialist commodity derivatives firms* and broader financial markets, systemic risks generated by these firms appear in the opinion of CESR/CEBS in general to be relatively low compared to the systemic risks generated by credit institutions and *ISD investment firms*<sup>27</sup> because even if the risks arising from *commodity derivatives* business are not different from those arising in the wider financial markets, the financial impact of failures of *specialist commodity derivatives firms* in general appears to be lower than failures of financial institutions. However, it is important to note that this conclusion is based on the general comparison between the different sectors (*specialist commodity derivatives firms* vs. credit institutions and/or *ISD investment firms*) rather than on a comparison between individual firms in these sectors.<sup>28</sup>

## PART C. REGULATORY FAILURE ANALYSIS

57. Questions 2 and 3<sup>29</sup> 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

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<sup>26</sup> US government-commissioned investigative report concerning the events leading up to the collapse of Amaranth Advisors LLC

<sup>27</sup> 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 credit institutions and ISD financial investment firms. In the commodities case studies examined in this report, systemic concerns were limited and contained."

<sup>28</sup> BaFin, Commission Bancaire and Bank of Slovenia are of the opinion that the conclusion in paragraph 12 of the second part of CEBS's technical advice cited in the footnote below requires further elaboration in two key respects: first, in relation to which institutions it is appropriate to compare *specialist commodity derivatives firms* to; and second, in relation to the interconnections between commodities markets and wider financial markets. For these members the conclusion of a significantly smaller magnitude of systemic risk concerns with respect to specialist commodities firms was mainly based on the observation that *specialist commodity derivatives firms* unlike credit institutions do not take deposits and that thus the aspect of depositor protection does not have to be factored into the assessment of their systemic risk. These members think that these concerns, however, do not apply to *ISD investment firms* either and that it is necessary to elaborate on this conclusion by separately comparing the systemic risk concerns caused by *specialist commodity derivatives firms* with those caused by credit institutions and those caused by *ISD investment firms*. With respect to systemic risk resulting from failures within a certain market, these members believe that the systemic impact posed by other *ISD investment firms* could be realised in a manner different from the systemic risk posed by *specialist commodity derivatives firms*, because the negative externalities to the wider financial system of failures of *specialist commodity derivatives firms* could often be rather indirect (i.e. via impacts on the market) than direct (i.e. via participation in markets other than commodities markets). Therefore, the conclusion of paragraph 12 of the second part of CEBS' technical advice deserves further elaboration by distinguishing concerns on direct negative externalities from concerns on indirect negative externalities.

<sup>29</sup> The advice on question 3 is covered in section V.

unintended effects 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 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?"

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

58. Under the current regulatory framework, some firms and activities in the *commodity derivatives* 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 derivatives firms*:

1. firms subject to *MiFID* and *CRD* requirements;
2. firms subject to *MiFID* and *CRD* but with a carve-out for *CRD* capital and/or large exposures requirements;
3. firms that are completely exempt from *MiFID*; and
4. firms subject to specialist national regimes for certain markets (e.g. oil markets, *energy* markets)

59. 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 a regulatory failure, as there may be reasons why different treatment of some firms is appropriate.

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

### **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 derivatives*. 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 derivatives 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* provides the possibility of a transitional exemption from the large exposures rules if those large exposures arise from commodities business.

## II. Potential significant competitive distortions

61. Question 2 of the Call for Advice asks whether differences in regulatory treatment between categories of firms that provide investment services in relation to *commodity derivatives* and across Member States could lead to regulatory failure and significant competitive distortions if the differential treatment of market participants were not justified. This is examined in subsection 1 and covers the following areas:

- a) regulation according to the main business of the group;
- b) capital requirements; and
- c) large exposures.

62. Irrespective of differential treatment between firms, regulatory failure could also arise if regulation is not appropriately tailored to the specific characteristics of *commodity derivatives markets*. This is discussed in subsection 2 and focuses on the following issues:

- a) market integrity (transaction reporting and market abuse); and
- b) client categorisation.

63. Subsection 3 analyses whether regulatory differences across the EU may give rise to competitive distortions.

## 1. Differential regulatory treatment of categories of firms

64. As described in section I firms carrying out the same activities in *commodity derivatives markets* are not necessarily subject to the same regulatory regime.

65. The following analyses whether this differential treatment across categories of firms could lead to competitive distortions and covers the following areas: regulation according to the main business of the group, capital requirements and large exposures.

### a. Regulation according to the main business of the group

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

1. *commodity derivatives* affiliates of banking/financial services groups are generally subject to *MiFID*;
2. *commodity derivatives* affiliates of non-financial firms trading in *commodity derivatives markets* are not necessarily subject to *MiFID*.

67. This situation arises from the exemptions in Articles 2(1)(i) and 2(1)(k) of *MiFID*. These are not available where an entity is part of a group the main business of which is the provision of investment or banking services. As a result entities which are not part of groups whose main business is investment or banking services may have lower costs when providing investment services in the circumstances set out in the exemptions than entities which are part of groups whose main business is the provision of investment or banking services.

68. 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 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, CESR/CEBS are of the view that systemic risks posed by *specialist commodity derivatives firms* are generally lower than those generated by credit institutions and *ISD investment firms*. The main business of the group in this case could therefore serve as a proxy for the degree of systemic risk, for example in the application of capital requirements.<sup>30</sup>

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

70. Regulatory failure could also result from differences in the interpretation and application of *MiFID* exemptions across EU Member States. (Chapter 1 of the CESR's response to the Commission's request for initial assistance on *commodity derivatives* and related business describes the divergent

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<sup>30</sup> BaFin, Commission Bancaire and Bank of Slovenia do not believe that the main business of the group should be used as a proxy for assessing the degree of systemic risk (in particular with regard to the application of capital requirements).

interpretations of Article 2(1)(i) of *MiFID*.) Such a regulatory failure may confer a competitive advantage on participants in *commodity derivatives markets* who are exempt from *MiFID*.

71. In the response to question 2 (relating to competitive distortions) of the Commission's Call for Evidence two respondents questioned the wisdom of making the application of *MiFID* exemptions dependent on whether the firm is part of a financial group or not. In contrast, respondents to the Consultation Paper generally state that they have no evidence that regulating *commodity derivatives* business according to the main business of the group creates competitive distortions. This may indicate that the amount of investment services business done by those firms which can use the exemptions is limited, and/or that since the directive came into effect there have been no examples where a change to the ownership of an entity has meant it can no longer use the exemptions in Article 2(1)(i) or Article 2(1)(k).

### **b. Capital Requirements**

72. 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.II). Systemic risk arguments are usually concerned with the possibility that the failure of a specific firm or set of firms may undermine the stability of the overall financial system.

73. 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 *CCR* exposures on derivatives, payment and settlement relationships for 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 credit institutions, *ISD investment firms*, and institutional investors - including hedge funds - in *commodity derivatives markets*.

74. 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 *CAD* may create competitive distortions in the *commodity derivatives markets*. *Specialist commodity derivatives 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 credit institutions 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.

75. However, CESR/CEBS doubt that this argument by itself justifies extending the scope of *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 *CRD* may not take fully into account the particularities of *specialist commodity derivatives firms*, including the fact that

as argued in the market failure analysis in Part B the systemic risks arising from *specialist commodity derivatives firms* appear to be lower than those stemming from credit institutions and *ISD investment firms*.

Even if the failure of a *specialist commodity derivatives 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 derivatives* 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.<sup>31</sup>

76. 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 with those involved in some gas and electricity industry activities<sup>32</sup>) can apply to the FSA for a waiver from the prudential requirements. *Energy* is defined as coal, electricity, natural gas (or any by-product or form of any of them), and oil.

77. 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 do not deal with retail clients.

78. 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.

79. The special OMP/EMP prudential regimes are a derogation from the main prudential requirements, reflecting the UK FSA's view of the specific nature of the specialist *commodity derivatives* business and the degree of systemic risk posed by these firms. 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.

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<sup>31</sup> BaFin, Commission Bancaire and Bank of Slovenia believe that the full application of the *CRD*, taking account of some amendments discussed in Part E, would properly address potential systemic risks arising from the activities of *specialist commodity derivatives firms*. In addition, these members believe that there is no evidence that *CRD* might not take fully into account the particularities of *specialist commodity derivatives firms*.

<sup>32</sup> 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).

80. The responses to the Consultation Paper invariably stated that the full application of *CRD* capital requirements to *specialist commodity derivatives firms* would impose a disproportionate regulatory burden. Two respondents mentioned that capital requirements would create barriers to access to the market. One of them also stated that participants might be driven out of the market. Another respondent thought that capital requirements could lead to business relocation by large firms and would impose high compliance costs for small firms that are not able to move. One respondent suggested that history shows that the failure of commodities firms in the past has had no systemic impact.

81. In conclusion, CESR/CEBS are of the opinion that *specialist commodity derivatives firms* generally do not pose the same level of systemic risk as credit institutions and *ISD investment firms* and therefore do not warrant the same degree of prudential regulation. The full application of *CRD* to *specialist commodity derivatives firms* is in their opinion therefore likely to impose a regulatory burden that is disproportionate to their potential systemic impact.<sup>33</sup>

### c. Large exposures

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

83. According to the preceding discussion, CESR/CEBS are of the opinion that the systemic risks generated by these firms are of a lower order than those posed by credit institutions and *ISD investment firms*. Consequently, the benefits of applying a large exposures regime to *specialist commodity derivatives firms* would also be lower.<sup>34</sup>

84. CESR/CEBS believe that 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 to entities acting as intermediaries for their group is likely to impose significant costs with respect to the exposures to the group to which the authorised entity belongs.

85. Specific costs arising from own funds requirements for exceeding large exposures limits are likely to result from the fact that *commodity* trading is almost always connected to high volume credit exposures because of common usages in certain commodities markets. Large credit exposures and free

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<sup>33</sup> BaFin, Commission Bancaire and Bank of Slovenia are of the opinion that it is not possible to distinguish between the systemic risks posed by *specialist commodity derivatives firms* and *ISD investment firms* and therefore consider it to be appropriate to apply the same prudential regulation to both sets of firms. It is these members' opinion that even if the systemic risk was different this would not be a sufficient reason for concluding that applying *CRD* would be an inappropriate burden. From the point of view of these members, it would be necessary to demonstrate, and they do not believe this has been done, that *CRD* does not appropriately address the risks of *specialist commodity derivatives firms*. The non-application of the *CRD* to *specialist commodity derivatives firms* is in the opinion of these members therefore likely to pose a threat to the aims of prudential regulation.

<sup>34</sup> BaFin, Commission Bancaire and Bank of Slovenia, for the reasons set out above do not believe it is possible to conclude that *specialist commodity derivatives firms* pose lower systemic risks than *credit institutions* and *ISD investment firms*. Consequently they do not believe that there would be lower benefits from applying a large exposures regime to *specialist commodity derivatives firms*.

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. Reducing the periods between delivery date and payment date could be difficult to achieve if a firm tried to go down this route alone. This would require its counterparties to agree to the change. The alternative way of protecting against defaults on large exposures by covering such exposures with sufficient own funds would result in additional costs caused by these market usages.

86. 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 resulting from commodities business on an individual basis, and, if the firm complies with the monitoring and management requirements of Article 45, to allow *specialist commodity derivatives firms* to exceed large exposure limits (resulting from commodities business (but not from other business of the firm) without additional capital requirements.
87. The responses to the Consultation Paper invariably stated that the full application of *CRD* large exposure requirements to *specialist commodity derivatives firms* would impose a disproportionate regulatory burden. One respondent noted that this is particularly relevant as, with the exception of commercial real estate, no physical collateral, e.g. traded physical commodities, is eligible under the large exposure regime.

## **2. Regulation which is not sufficiently adapted to the *commodity derivatives market***

88. Competitive distortions may also arise where there is equal regulatory treatment for all firms but regulation is not sufficiently adapted to the specifics of the *commodity derivatives markets*. Market integrity issues and the *MiFID* client categorisation rules are discussed below.
89. The regulatory failure analysis in the Consultation Paper also discussed market transparency and the definition of financial instruments. The analysis has not found clear evidence for regulatory failure in these cases. This was also confirmed by the responses to the Consultation Paper.

### **a. Market integrity (transaction reporting and market abuse)**

90. This sub-section on transaction reporting and market abuse is without prejudice to the advice expected from the Joint CESR/EREG Group.
91. The market failure analysis in Part B indicated that market abuse can arise in the trading of *commodity derivatives*. Issues of market integrity are therefore of relevance in the *commodity derivatives markets*.
92. *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.
93. The Consultation Paper asked whether for non-electricity and gas *derivatives* contracts the transaction reporting requirements in *MiFID* support market regulation. All except two respondents questioned whether transaction reporting is beneficial. Reasons stated were that it is not necessary for market

supervision and that position reporting is a more appropriate tool. Further it might create a disadvantage for smaller market players and costs outweigh the benefits. One respondent thought that the current scope of transaction reporting requirements adequately supports market regulation but that an extension to *OTC* contracts would create a disproportionate burden.

94. 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.I, 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 a regulatory failure with respect to market abuse.
95. The fact that commodities *MTFs*, which represent a non-negligible share of total *commodity derivatives* trading, are not covered by the Market Abuse Directive could also result in regulatory failure. *Commodity derivative* contracts traded on *MTFs* or on an *OTC* basis are only covered by the Market Abuse Directive to the extent that ‘...their value depends on..’ a contract traded on a regulated market.
96. 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 derivatives*.<sup>35</sup>
97. CESR/CEBS generally believe, however, that issues related to market abuse should be addressed in the Commission’s wider review of the Market Abuse Directive.

## **b. Client categorisation**

98. As in other financial markets, *MiFID* applies the principle of graduated client protection to *commodity derivatives markets*. It is important to recognise in this context that:
1. *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; and
  2. the characteristics of clients in *commodity derivatives markets* can be different from those of clients in other financial markets.
99. The boundary lines for professional clients established by *MiFID* may not adequately reflect the client characteristics in *commodity derivatives 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.

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<sup>35</sup> [http://ec.europa.eu/internal\\_market/securities/docs/esme/mad\\_070706\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/esme/mad_070706_en.pdf)

100. 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. This issue was raised by some respondents to the Commission's Call for Evidence and also in some responses to the CESR/CEBS call for evidence.<sup>36</sup>
101. One issue that has been raised in several responses to the Consultation Paper is that firms subject to *MiFID* are reluctant to do *commodity derivatives* business with entities that would have to be classified as retail clients.
102. Further problems can arise due to the "grandfathering" of the client categorisation of pre-*MiFID* clients under the provisions of Article 71 (6) of *MiFID*. Sophisticated pre-*MiFID* clients that did not meet the new requirements for professional clients would still have been categorised as professional clients under certain conditions. Therefore these clients are at an advantage compared to comparable "post-*MiFID*" clients. However, those "grandfathered" clients are not able to switch their broker as they would then be classified as retail clients. This issue has also been raised by one respondent to the CP who estimated that 10% of their pre-*MiFID* clients would not meet the new requirements for professional clients.
103. Question 13 of the Consultation Paper asked whether there is any evidence of potential problems with current client categorisation rules and the scale of these problems. Generally this question has been answered in conjunction with question 19 of the Consultation Paper (The case for changing the client categorisation regime?). Therefore further discussion of the responses is provided in section C.III. which deals with policy recommendations on client categorisation rules.

### **3. Regulatory differences across the EU**

104. Another area which may give rise to competitive distortions are the existing regulatory differences across the EU. These differences arise because of:
1. super-equivalence with respect to EU rules (e.g. special *energy* and oil market regimes in the United Kingdom);
  2. different implementation of EU rules (Chapter 1 of CESR's Response to the Commission's request for initial assistance on *commodity derivatives* and related business describes the divergent interpretations across EU Member States of Article 2(1)(i) of *MiFID*); and
  3. different rules in areas that are not covered by EU legislation (as described in the first part of CEBS's technical advice).
105. Question 2 of the Commission's previous Call for Evidence asked about competitive distortions in general. The responses were mixed. Two respondents stated that there are competitive distortions, while two others argued that this is not the case. One respondent argued that there are no competitive distortions on a national level but that local requirements

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<sup>36</sup> For a more detailed description of these responses see part D. IV. on client categorisation and conduct of business regulation.

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.

106. The responses to the Consultation Paper confirmed that 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 and runs counter to the goal of creating a single European market for *commodity derivatives* business.

#### **4. Conclusion**

107. The discussion on differences in regulatory treatment between firms focussed on regulation according to the main business of the group and *CRD* capital and large exposure requirements. CESR/CEBS believe that application of the *CRD* requirements (including the large exposures regime) to *specialist commodity derivatives firms* would be disproportionate and would lead to regulatory failure.<sup>37</sup> Industry responses to the Consultation Paper state invariably that they believe full application of *CRD* would be disproportionate.

108. CESR/CEBS's analysis has also identified that there may be issues with the current transaction reporting requirements and client categorisation rules.

109. Furthermore, CESR/CEBS believe that the existing regulatory differences across the EU may give rise to competitive distortions.

### **III. Free movement of services**

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

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

### **IV. Regulatory arbitrage**

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

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

1. A large Dutch *energy* producer recently moved its trading desk to Geneva. The implementation of *MiFID* played a role in this decision.

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<sup>37</sup> BaFin, Commission Bancaire and Bank of Slovenia do not share this view.

2. 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 *MiFID*, the firm can use its passport rights to continue conducting business in the United Kingdom.

114. 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 exempted from regulation.

115. With one exception the responses to the Consultation Paper recognised the potential for regulatory arbitrage. There was a focus on different interpretations among European regulators and gold-plating. One respondent suggested that this might lead to business relocations. Another respondent mentioned that regulatory arbitrage may result from the fact a company is regulated where it is located as opposed to where it carries on its trade. However, changing this would not eliminate the possibilities for regulatory arbitrage. One respondent noted that there is no potential for regulatory arbitrage in the metals business. Due to the combination of the rules of the London Metals Exchange and the need to be authorised by the FSA firms have to locate in the UK.

## **V. Correction of market/regulatory failures in the short to medium term**

116. To the degree that market failure has been identified, in the opinion of CESR/CEBS it is unlikely that the market will be able to correct it in the short to medium term. The same conclusion holds for the regulatory failures that have been recognised, since these failures stem from *MiFID* provisions and/or from differences in regulatory treatment across the EU.

## **PART D. MIFID QUESTIONS 4 AND 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. Transparency**

## Transparency: Market efficiency, investor protection and market integrity

117. This sub-section on market transparency is without prejudice to the advice expected from the joint CESR/EREG Group looking at issues concerning record keeping and transparency of transactions in electricity and gas supply contracts and derivatives.
118. Transparency in financial markets is not an end in itself but a means to an end. It is used to promote market efficiency, investor protection and market integrity. Promoting these objectives does not require complete transparency. In particular there can be a trade-off between transparency and market efficiency. Participants need some transparency to have the confidence to trade but too much transparency can deter participation by raising the potential costs of committing capital to trading.
119. Transparency in relation to financial markets is an elastic term. It can be thought of as encompassing information about companies whose securities are offered to the public or are admitted to trading on regulated markets, information disseminated to the market about expressions of interest in trading and completed transactions and information about the production and supply of commodities.
120. Regulatory transparency in relation to financial markets in the EU is mainly governed by the Prospectus, Market Abuse, Transparency and Markets in Financial Instruments Directives.
1. **Prospectus Directive.** This deals with initial disclosure by or about firms issuing securities to the public or whose securities are admitted to trading on a regulated market.
  2. **Market Abuse Directive.** This deals with ad-hoc disclosures to market participants of price-sensitive information related to financial instruments admitted to trading on regulated markets and disclosures in relation to investment recommendations.
  3. **Transparency Directive.** This deals with periodic disclosures by firms whose securities are admitted to trading on regulated markets.
  4. **MiFID.** This deals with reporting by investment firms to competent authorities about trading activity ('transaction reporting'), publication by investment firms of expressions of interest in trading ('pre-trade transparency') and completed transactions ('post-trade transparency') and the obligations on regulated markets and *MTFs* to ensure there is sufficient information available to market participants about the instruments admitted to trading on their markets.
121. All of these Directives bear to a lesser or greater extent on the trading of *commodity derivatives*. The first three mainly affect firms involved in the production, distribution or consumption of commodities whose securities are offered to the public or are admitted to trading on regulated markets. *MiFID* more directly affects firms providing investment services in relation to *commodity derivatives* and the organised markets where *commodity derivatives* are traded. However, *MiFID's* pre- and post-trade transparency obligations on investment firms only apply to shares admitted to trading on regulated markets.

122. In addition to transparency required by financial services legislation, EU energy legislation also has requirements relating to disclosure of information about *energy* production, while the market also provides various forms of transparency. These include:

1. media dissemination of news regarding developments which might affect the supply of and demand for commodities (such as recent reporting of developments affecting the BTC pipeline);
2. dissemination to market participants by investment firms of expressions of interest in trading; and
3. dissemination of information to market participants about fundamentals and transactions (including *OTC* transactions) by data vendors.

## 1. Market efficiency and investor protection

123. *MiFID* imposes only limited obligations with respect to pre-trade and post-trade transparency in *commodity derivatives*. Both regulated markets and *MTFs* are required to have rules and procedures for 'fair and orderly' trading<sup>38</sup>, while *MTFs* have to make available, or be satisfied that their users can access, sufficient information to make investment judgements<sup>39</sup>. As indicated above there are no pre-trade or post-trade transparency obligations for investment firms with respect to *commodity derivatives*.

124. As also indicated above, however, an absence of precise regulations governing transparency does not mean that there is no relevant information for market participants. Information is available from regulated markets, *MTFs*, broker screens and through data vendors. This includes some information on *OTC* trading.

125. The market failure analysis also suggested that information about the fundamentals of supply and demand for commodities tend to be more important in driving investment decisions in relation to *commodity derivatives* than information about expressions of trading interest and completed transactions.

126. In its summary of the responses to its Call for Evidence on the review of *commodity derivatives*<sup>40</sup>, the Commission noted that there was no enthusiasm for extending to *commodity derivatives* the type of pre-trade and post-trade transparency arrangements that apply to shares under *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.

## Conclusion

127. 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

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<sup>38</sup> Articles 39(d) and 14(1) of Directive 2004/39/EC

<sup>39</sup> Article 14(2) of Directive 2004/39/EC

<sup>40</sup> Published on 14 August 2007 and available at:  
[http://ec.europa.eu/internal\\_market/securities/isd/MiFID\\_reports\\_en.htm](http://ec.europa.eu/internal_market/securities/isd/MiFID_reports_en.htm)

this as a major concern which deters them from participating in the markets. They believe that there are already sufficient sources of price information and that in trading *commodity derivatives* non-price information relating to supply and demand is usually of greater importance in trading decisions than data about the trading of *commodity derivative* contracts.

128. Overall therefore CESR/CEBS do not believe that there is much benefit to be gained from mandating through legislation greater pre- and post-trade transparency in *commodity derivatives markets*<sup>41</sup>, whether of the sort which applies to equities under *MiFID* or aggregate information about transactions or positions. It is of course open to market participants to build on existing market-driven transparency.<sup>42</sup>

129. As indicated above, the provisions governing transparency on regulated markets and *MTFs* in respect of *commodity derivatives* are fairly similar. CESR/CEBS do not believe that it is necessary to change *MiFID* in this area.

## 2. Market integrity

130. The two main ways that financial regulation attempts to deal with market abuse through transparency is by requiring price-sensitive information to be disclosed to the market and data on transactions to be reported to competent authorities. CESR/EREG are considering the issue of whether there should be additional legal requirements for the release of fundamental data in the electricity and gas sectors.

131. CESR/CEBS have received no specific proposals relating to the release of fundamental data in other sectors. In relation to some commodities, such as oil or metals, any EU-specific requirements are only likely to be capable of providing part of the picture about supply developments. Much of the relevant information will be held by non-EU firms or public sector bodies.

132. The absence of specific requirements requiring the release of fundamental information does not however mean that such information is not available. As mentioned above, a lot of information is available through the ad-hoc and ongoing releases of companies whose securities are admitted to trading on regulated markets, through subscription to data vendors and through subscription and free media outlets.

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

134. In many jurisdictions, this *MiFID* requirement has meant that investment firms were placed for the first time under an obligation to report transactions relating to *commodity derivatives*. To facilitate the introduction of this new obligation, it was agreed that transactions in non-securities derivatives (including *commodity derivatives*) would be reported through the

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<sup>41</sup> Leaving aside electricity and gas derivatives as they are subject to the work of CESR/EREG, see also paragraph 117

<sup>42</sup> The Autorité des Marchés Financiers (AMF) does not share this view and believes that increased post-trade transparency of *OTC* commodities derivatives trading, properly calibrated, would be likely to bring net economic benefits to the market. This objective could be attained either through regulatory intervention or through an industry-led initiative within a framework defined by regulators.

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.

135. As well as protecting market integrity, transaction reporting also potentially serves several other purposes in relation to *commodity derivatives*: it helps supervisors monitor investment firms' compliance with conduct of business obligations such as best execution and it helps supervisors monitor market trends.

136. In practice, protecting market integrity has usually been considered the most important of these purposes, although *MiFID* may have changed this to some extent by abolishing the concentration rule and applying best execution to all financial instruments. However, requiring investment firms to send transaction reports directly to competent authorities may not be necessary for the fulfilment of the tasks of competent authorities if they receive the relevant transactions from the regulated markets.

137. 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 potential manipulation in these markets, whereas transaction reports may have more of a role to play in relation to insider trading.

138. Some of the responses to CESR/CEBS's Consultation Paper provided a view that, given *MiFID*'s coverage and exemptions, it is likely that transaction reporting of commodities derivatives yields only limited benefits which do not outweigh the costs involved. One respondent said that they favoured position reporting to regulated markets over transaction reporting to competent authorities. Another queried the utility of expanding transaction reporting to cover *OTC commodity derivatives* transactions.

139. In the U.S., the CFTC's large trader data reporting system requires exchange clearing members to submit daily reports to it which show the *futures* and options positions of traders with positions at or above set reporting levels. This data supplements the clearing member data required to be provided to the CFTC on a daily basis by exchanges, in particular because it can help identify where a single trader controls substantial portions of the customer positions with more than one clearing member and therefore could control a large portion of the market. Moreover, record keeping requirements on every trader who holds or controls a reportable *futures* or option position includes maintaining records concerning *OTC* positions and transactions in the *commodity*. This ensures 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<sup>43</sup>.

140. There is no specific requirement in *MiFID* in relation to position reporting. However, on the basis of Article 43 regulated markets have to monitor transactions and seek to ensure that their markets are not being used

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<sup>43</sup> 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/cot_about.html)  
<http://www.cftc.gov/marketreports/commitmentsoftraders/index.htm>

for abusive purposes. In the UK regulated markets which trade commodities require their members to provide position reports as part of meeting these requirements. These reports are available to the FSA but it is the market operators who are on the front line in efforts to detect possible instances of market abuse.

## Conclusion

141. *Commodity derivatives markets*, like other financial markets, are subject to informational asymmetries which can give rise to abusive market conduct. The Market Abuse Directive applies to *commodity derivatives* contracts admitted to trading on regulated markets and to instruments priced off such contracts. The Commission is reviewing the Market Abuse Directive and it will be important that this review considers the effectiveness of the Directive as it relates to *commodity derivatives*.
142. One way of preventing market abuse is to ensure that price sensitive information is available to market participants. CESR/ERGEG are looking at the availability of fundamental information in the electricity and gas markets in the process of the updating of sectoral Directives. CESR/CEBS are not making any proposals in relation to the release of fundamental information in other sectors not least because in some commodities, such as oil and metals (the derivatives of which are actively traded in the EU) many key developments take place outside the EU.
143. There are questions as to the relevance of transaction reporting requirements in Article 25(3) of *MiFID*<sup>44</sup> for the fulfilment of the competent authorities' tasks in upholding market integrity in *commodity derivatives markets*. However, CESR/CEBS consider that current arrangements where regulated markets provide transaction reports in relation to *commodity derivatives* to their home Member State competent authorities continue to provide a satisfactory solution.
144. Position reporting does have a role to play in protecting market integrity in *commodity derivatives markets*. But collecting such information should be part of the role of market operators as they seek to comply with their obligations under Article 43 of *MiFID*. Where such information leads market operators to suspect market abuse, they are already under an obligation to report this information to competent authorities. Requiring position reports to be sent direct to competent authorities by investment firms would undermine the role of market operators as the front line in ensuring their own markets are not used for abusive purposes.

## II. Organisational requirements

145. Articles 13 and 18 of *MiFID* (and the related implementing measures in Chapter II of the implementing Directive<sup>45</sup>) 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:

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<sup>44</sup> Leaving aside electricity and gas derivatives as they are subject to the work of CESR/ERGEG, see also paragraph 117

<sup>45</sup> Directive 2006/73/EC

- 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.

146. In the main, *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 investment services and activities undertaken in the course of that business. None of the responses to CESR/CEBS's Call for Evidence commented directly on these organisational requirements.

147. The responses to the Consultation Paper on organisational requirements expressed some concerns about applying requirements designed for securities and financial derivatives intermediaries to *specialist commodity derivatives firms*. It was suggested that such concerns could be alleviated by keeping many firms whose main business relates to commodities outside the scope of the Directive and by a proportional application of the requirements to firms inside the scope of the Directive. One respondent said – without providing much elaboration - that Article 9 of *MiFID* ('Persons who effectively direct the business') and the organisational separation of operational functions posed a particularly heavy burden for small *specialist commodity derivatives firms*.

148. CESR/CEBS's approach to the exemptions is discussed below. However, CESR/CEBS accept that setting the boundaries of regulation involves trying to balance the costs of regulation, which in this case include the costs of meeting *MiFID* organisational requirements, against the benefits of regulation. A significant number of *MiFID* firms other than *specialist commodity derivatives firms* are small firms and the organisational requirements, including those relating to the organisational separation of operational functions, have been applied to them in a proportionate manner.

149. CESR/CEBS believe that the organisational requirements of *MiFID* support the intended aims of market regulation of investment firms providing investment services relating to *commodity derivatives*. 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. CESR/CEBS are not aware that Articles 13 and 18 of *MiFID* and their associated implementing measures cause investment firms that provide investment services relating to *commodity derivatives* any particular difficulties related to the nature of *commodity derivatives* business. Therefore CESR/CEBS do not believe they need adapting for *specialist commodity derivatives firms* or other *MiFID* firms engaged in *commodity derivatives* business, in particular against the background that *MiFID* includes the principle of proportionality.

### **III. Client categorisation and conduct of business regulation**

150. The client categorisation regime and the conduct of business rules in *MiFID* are the means by which *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.
151. Article 71(6) of *MiFID* granted investment firms (across the full range of investment services) flexibility to continue to categorise existing professional clients as professional clients under *MiFID* without applying the criteria in Annex II of *MiFID* in full. The criteria in Annex II of *MiFID* 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.
152. All of the respondents to the Commission's Call for Evidence on *commodity derivatives* 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.
153. Some of the respondents to the Commission's Call for Evidence suggested that the client categorisation rules in *MiFID* do not necessarily reflect the 'sophisticated' nature of *commodity derivatives markets*. In order to be automatically considered a professional client under Annex II (I) of *MiFID* entities have to fall within one of the categories of entity or public body set out there or meet two of the quantitative criteria set out for 'large undertakings'. In addition, Annex II (II) of *MiFID* allows some clients to be treated as professionals on request provided they can meet certain criteria (two of which relate to the frequency of their trading and the size of their portfolio). Some respondents said that the size criteria in Annex II (I) can be difficult to satisfy for subsidiaries, and that the criteria in Annex II (II) are aimed at individuals rather than entities. They argued for changing the client categorisation rules in *MiFID*. One response also suggested that the benefits of the elective eligible counterparty regime are undermined by the fact that Article 24(3) of *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.
154. Some of the same points were made in response to CESR/CEBS's Call for Evidence. In addition, one respondent to the Call for Evidence offered a specific suggestion for changing the client categorisation regime for *commodity derivative* business. This respondent recommended:
1. allowing investment firms to treat undertakings as professionals if they are part of groups that meet the existing size thresholds on a consolidated basis;

2. considering firms whose shares are listed on European markets (or other markets with equivalent standards) as per se professional clients; and
3. in relation to *commodity derivatives* business, including undertakings whose main business is trading in commodities or the underlying of any such instrument or that are producers or professional users of commodities.

155. The responses to CESR/CEBS's Consultation Paper were similar to those to the Call for Evidence. Several respondents said that the *MiFID* client categorisation rules could result in some sophisticated clients being inappropriately classified as retail clients. One respondent estimated that 10 per cent of its client base would not meet the criteria for elective professional status if they had not been able to classify them as professionals under the provisions in Article 71(6) of *MiFID*. As well as the suggestion mentioned above for modifying the client categorisation regime for *commodity derivatives* business one respondent suggested that firms should be able to treat clients (which are undertakings) as professionals on request solely on the basis of a qualitative assessment of the client's ability to make their own investment decisions and understand the risks involved.

156. The provisions of Articles 19, 21, and 24 of *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 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. CESR/CEBS therefore do not believe that the conduct of business rules in *MiFID* need to be adapted for *commodity derivatives* business as long as the client categorisation regime works adequately in these markets.

157. There was little comment on specific conduct of business issues in the responses to CESR/CEBS's Call for Evidence or responses to the Consultation Paper 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 here, its scope is broader than advice relating to *commodity derivatives* and CESR/CEBS therefore do not consider it is appropriate to deal with it in this review.

## Conclusion

158. The client categorisation regime is central to the way the conduct of business regime in *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. CESR/CEBS do not believe that any changes to the client categorisation regime should be made in relation to *commodity derivatives* business undertaken by clients who are individuals. In the light of the concerns expressed by industry, however, CESR/CEBS believe that a change should be made in relation to undertakings. CESR/CEBS's preference is to enable firms to treat such clients on request as

professionals where, after an adequate assessment, they believe that the clients are capable of making their own investment decisions and understanding the risks involved in the light of the nature of the transactions envisaged.

159. CESR/CEBS believe that a similar transitional provision to that in Article 71(6) of *MiFID* regarding professional clients would be appropriate if additional firms were to be brought within the scope of *MiFID* as a result of any changes to the *MiFID* exemptions following the Commission's review of the regulation of *commodity derivatives*.
160. CESR/CEBS believe that with an appropriate client categorisation regime *MiFID* conduct of business rules do not pose a particular problem for firms undertaking *commodity derivatives* business. Therefore CESR/CEBS do not believe that it is necessary to change these rules for *commodity derivatives* business.

#### IV. Financial Instruments

161. Articles 38 and 39 of the *MiFID* Implementing Regulation set out the criteria that certain *commodity derivative*<sup>46</sup> contracts have to meet in order to be considered as having the characteristics of other derivative financial instruments (and, with respect to *commodity derivatives* strictly defined, as not being for commercial purposes) and therefore falling within the scope of *MiFID*.
162. Most respondents to the Commission's Call for Evidence on *commodity derivatives* thought that the definition of financial instruments in *MiFID* as it relates to *commodity derivatives* is adequate and does not require amendment. The responses to CESR/CEBS's Call for Evidence made the following points concerning the definition of financial instruments:
1. 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 *MiFID*;
  2. the reference to freight rates is unclear insofar as a freight contract is not itself a *commodity*; and
  3. the term 'commercial' is not suitable for separating 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.
163. 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<sup>47</sup>, and needs to be considered in another context. The reference to freight rates appears in point (10) of section C of Annex I of

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<sup>46</sup> 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. CESR/CEBS 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.

<sup>47</sup> See ISDA press release of 17 April at <http://www.isda.org/press/presso41708netting.html>

*MiFID*. This category of financial instruments covers exotic rather than *commodity derivatives*, strictly defined, and as such CESR/CEBS 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.

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

1. they provide additional clarity on the list of underlyings to which *exotic derivatives* relate (the *MiFID* Implementing Regulation also defines a '*commodity*');
2. they ensure that all cash-settled<sup>48</sup> *exotic derivatives* contracts are included in the definition of financial instruments;
3. they ensure that all physically-settled<sup>49</sup> *exotic derivative* contracts traded on regulated markets and *MTFs* 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.

165. 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:

1. it is traded on a third-country market that is equivalent to a regulated market or *MTF*;
2. it is expressly stated to be traded on or subject to the rules of a regulated market, *MTF*, or an equivalent third country market; or
3. it is expressly stated to be equivalent to a contract traded on a regulated market, *MTF*, or an equivalent third country market.

166. 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 derivatives***

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<sup>48</sup> A contract which is settled in cash or may be settled in cash at the option of one of the parties other than by reason of a default or other termination event.

<sup>49</sup> A contract where there is no option for cash settlement other than by reason of default or other termination event.

167. 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. CESR/CEBS 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 *MiFID*, and not C(5) and C(6) as well. It would be more natural for 'commodity' to be defined in level 1 of *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', CESR/CEBS do not believe that this has led to supervisors applying different meanings to the word for different categories of financial instruments.

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

## **2. Cash-settled *exotic derivatives***

169. The inclusion of all cash-settled *exotic derivatives* in the definition of financial instruments via Article 38(3)(a) of the *MiFID* Implementing Regulation parallels the inclusion of *commodity derivatives* in C(5) of Section C of Annex 1 of *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 derivatives* traded on a regulated market or *MTF***

170. The inclusion of all *exotic derivatives* traded on regulated markets and *MTFs* in the definition of financial instruments via Article 38(3)(b) of the *MiFID* Implementing Regulation parallels the inclusion of *commodity derivatives* in C(6) of Section C of Annex I to *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.

171. However, this approach raises two issues:

1. 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 *MTFs*. However, it might undermine the status of regulated markets and *MTFs* if the same protections did not apply to all contracts traded on such entities.
2. Second, there is a degree of circularity in *MiFID* definitions of financial instrument, regulated market, and *MTF*. Under C(6) of Section C of Annex I to *MiFID* and Article 38(3)(b) of the *MiFID* Implementing Regulation physically-settled *commodity derivatives* contracts are

*MIFID* financial instruments when traded on a regulated market or *MTF*. In Article 4 of *MiFID*, regulated markets and *MTFs* 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 derivatives* 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 *MiFID*.

#### 4. Physically-settled *commodity derivatives*<sup>50</sup>

172. Articles 38(1) and (2) of the *MiFID* Implementing Regulation set the boundaries that determine which physically-settled *commodity derivatives* contracts (that are not traded on regulated markets or *MTFs*) 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 derivatives* strictly defined, are not for 'commercial purposes'.

173. Some of the responses to the Commission's Call for Evidence on *commodity derivatives* 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."

174. 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 for whether or not a contract is for commercial purposes. CESR/CEBS therefore do not believe that the use of the term 'commercial purpose' creates problems of interpretation.

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

1. Article 38(2), which defines physically-settled 'spot contracts', which are automatically not financial instruments; and
2. Article 38(1), which determines when physically-settled contracts that are not spot contracts are financial instruments.

176. The definition of 'spot contract' is intended to exclude from the definition of financial instruments those contracts which are traded principally

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<sup>50</sup> Many *exotic derivatives* will be cash-settled because the underlyings of these instruments, such as with weather derivatives, cannot be delivered.

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'.

177. 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.

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

1. not all of the services/activities performed by investment firms are related to financial instruments; and
2. 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*).

179. There is inevitably a degree of arbitrariness in regulatory boundaries. There is often no right dividing line which enables such boundaries to be easily drawn and widely accepted. If the boundaries follow the activities of credit institutions and *ISD investment firms*, this may risk 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.

180. Several respondents to the Consultation Paper said that they thought the definition of financial instruments in *MiFID* as it applies to *commodity derivatives* contracts was sufficiently clear. They did not believe that it would be helpful to reopen discussion of this subject. However, two respondents asked for additional clarity on:

1. when under Article 38 paragraph 1 (a) (iii) of the implementing regulation a contract is deemed to be equal to a *future* (in particular whether it must be cleared and involve margin payments); and
2. the meaning of 'freight contract' in Section C (10) of Annex I to *MiFID*.

181. According to the *MiFID Implementing Regulation* a contract will be equivalent to a contract traded on a regulated market, *MTF* or third country trading facility where it is 'expressly stated to be equivalent', is not a spot

contract and meets the conditions in points (b) and (c) of Article 38 (1). This means either that it must be cleared or 'there are arrangements for the payment or provision of margin in relation to the contract.' The point about freight contracts is the same as that raised in response to CESR/CEBS's Call for Evidence. In the introduction to the discussion of financial instruments CESR/CEBS concluded that further clarification is not necessary regarding the meaning of 'freight contract'.

182. Several respondents to the Consultation Paper said there was no evidence that physically-settled *commodity derivatives* contracts were being written in such a way as to deliberately avoid regulation. However, one respondent said that many companies had stopped using a regulated market which trades *commodity derivatives* contracts to get absolute certainty that they were outside regulation (albeit that they probably fell within one of the exemptions).

183. CESR/CEBS believe that there is no need to revise the definition of financial instruments in *MiFID* as it relates to *commodity* and *exotic derivatives*. The existing definition seems to provide an adequate degree of clarity. The use of 'expressly stated to be equivalent' does give some discretion to market participants to determine whether or not contracts are financial instruments. However, CESR/CEBS have only very limited evidence that this is leading to regulatory arbitrage.

#### **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. preempting 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?

## VI. Articles 2(1) (i) and (k) of *MiFID*

### 1. General considerations

184. The following paragraphs discuss the scope of application of *MiFID* to firms undertaking investment activities or providing investment services relating to *commodity derivatives*. Conclusions on this subject are linked to the *CRD* and *MiFID* regime that applies to *commodity derivatives* firms and business. Whether it is appropriate to bring certain firms within regulation depends on the regime that would apply to them if they were regulated.

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

1. 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 derivatives* business. The impact of retaining or eliminating the exemption obviously depends on how the exemption is interpreted.
2. Second, CESR/CEBS 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 incomplete. 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 necessarily makes it difficult to assess the impact of the exemptions and of any possible changes to them.

186. 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 give rise to significant competitive distortions.

187. The respondents to CESR/CEBS's Call for Evidence also expressed different views on the desirability of retaining the exemptions in Articles 2(1) (i) and (k) of *MiFID*. They cited two main arguments for retaining the exemptions:

1. 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 derivatives* given the nature of the participants in these markets, and

2. insufficient time has passed since *MiFID* implementation to assess the impact of the new regime on the trading of *commodity derivatives*.

188. 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."

189. 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 *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; and
- firms eligible for the exemption should be allowed to opt in to regulation under *MiFID*.

190. 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.

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

192. The views expressed in response to CESR/CEBS's Call for Evidence were very similar to those expressed in response to CESR/CEBS's Consultation Paper. Respondents either favoured retention of the existing exemptions or the CDWG's proposal for an exemption for dealing on own account.

193. 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 *MiFID*:

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

194. 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.

195. **Clarifying guidance.** CESR's October 2007 response to the Commission's request for initial assistance on *commodity derivatives* outlines the areas of consensus and disagreement regarding the practical application of the exemptions under Articles 2(1)(i) and (k) of *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 derivatives*. 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 *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 *MiFID*'s definitions of regulated markets and *MTFs*.

196. Responses to both the Commission's and CESR/CEBS's Call for Evidence expressed a clear desire to have a regime for the regulation of *commodity derivatives* which is legally certain and consistently interpreted throughout the EU. Outside of a determination by the ECJ complete certainty and complete consistency may well be impossible to achieve. It is also unclear whether there is a more significant problem of certainty and consistency in relation to the provisions of *MiFID* that relate to *commodity derivatives* as against other investment services. However, there are various ways in which progress can be made towards the objectives of certainty and consistency.

197. The starting point for achieving certainty and consistency must be the legislative acts themselves. They are more likely to promote certainty and consistency where they reflect wide agreement about what is to be achieved and where this agreement is transformed into clear language with, as necessary, detail being provided in implementing legislation. Whilst there is useful role for guidance to play, particularly in respect to promoting consistency of interpretation, it is not legally binding and cannot of itself provide legal certainty.

198. The main forms of guidance are Directive recitals, a Commission interpretative communication, level 3 recommendations and Commission and CESR Q&A databases. Of these forms of guidance legislative recitals may be of most assistance in helping to understand what legislators intended, whilst Level 3 recommendations may have a greater role to play in promoting consistent interpretation. The latter, however, cannot be expected to resolve significant uncertainties in the scope of application of European legislation.

199. **Optionality.** The retention of the exemptions may also mean that there are some firms that wish to take advantage of the *MiFID* passport but fall within the exemptions. Some responses to CESR/CEBS's Call for Evidence and Consultation Paper suggested that in these circumstances a firm should be able to opt in to *MiFID*. If such a situation arises CESR/CEBS believe that a firm will in practice be able to opt in to *MiFID* by applying for authorisation with relevant permissions but how this is achieved may vary from Member State to Member State. However, some market participants have expressed concern that this may not always work in practice and would prefer greater legal certainty by making it clear in *MiFID* that it is intended that exempt firms should be able to opt in. Therefore, CESR/CEBS recommend that the Commission should consider whether an additional Article could be included into *MiFID* which would clarify that firms covered by the exemptions relating to commodity derivatives in Article 2 shall not be prevented from being authorised as investment firms.
200. **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 over the extent to which a single market directive can harmonise the regulation of firms which are exempt 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 *MiFID* exemptions.

## 2. Options

### a. Retaining the exemptions

201. As noted above, one of the respondents to CESR/CEBS's 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 regulation may cause.
202. The regulation of *commodity derivatives* 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 derivatives* business. Decisions emerging from this review need to ensure that a regulatory regime for *commodity derivatives* is put in place which will provide certainty for market participants.
203. The European Commission's original rationale<sup>51</sup> for the exemptions which became Articles 2(1) (i) and (k) was twofold:

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<sup>51</sup> 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](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.

1. 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; and
2. to accommodate the lack of consensus on the prudential arrangements that should apply to *specialist commodity derivatives firms*.

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

205. 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 derivatives* is within the scope of *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.

#### **b. Modifying the exemptions**

206. Modification of the exemptions could take account of agreement on an appropriate prudential regime for *specialist commodity derivatives firms* whilst still allowing for some of the specificities of *commodity derivatives* business. It could permit a remodelling of the exemptions so that they more clearly deal with the Commission's desire to keep out of the scope of *MiFID* market participants trading on own account as part of running a primarily non-financial business.

207. CESR/CEBS do not believe that it is appropriate to apply the exemptions differently to firms undertaking business relating to *commodity derivatives* with different underlyings. There is no evidence to suggest this would be appropriate and as a result it would create needless complexity.

#### **c. Removing the exemptions**

208. Removing the exemptions in Articles 2(1)(i) and (k) would treat *commodity derivatives* 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 *MiFID*. Such an approach implicitly assumes that undertaking investment activities and performing investment services relating to *commodity derivatives* raises the same regulatory issues as trading in other financial instruments.

209. Removing 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 in Article 2 of *MiFID*. However, these exemptions are not specifically directed at *commodity derivatives* business,

which could cause some difficulties, particularly in relation to Article 2(1)(c) and (d).

210. The 'incidental' exemption in Article 2(1)(c) is likely to be of strictly limited relevance to the *commodity derivatives* business. It covers<sup>52</sup> 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 derivatives* 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. Removal of the exemptions in Article 2(1)(i) and 2(1)(k) may have the effect that entities such as ship brokers and agricultural co-ops stop providing investment services relating to *commodity derivatives*.

211. 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), "this exemption should be regarded as a very restricted one".)<sup>53</sup> 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)." Similar concerns were expressed by ESME.

212. Beyond the issue of what constitutes a market maker (as defined in Article 4 of *MiFID* this term is not limited to firms that are designated as market makers under the rules of regulated markets or *MTFs*), there are two main parts of Article 2(1)(d) that may give rise to a lack of clarity and certainty. 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 derivatives*?

## Conclusion

213. The exemptions in Articles 2(1)(i) and (k) of *MiFID* were intended, at least in part, to provide a temporary solution to the lack of a specific capital regime for *specialist commodity derivatives firms*. It is therefore appropriate that the exemptions should be revised in conjunction with the development of an appropriate capital regime for such firms.

214. Deletion of the exemptions in Articles 2(1)(i) and (k) could have unforeseen consequences. There is a danger that because other exemptions do not take full account of the specificities of *commodity derivatives markets* and their participants, some primarily non-financial firms which do not raise similar regulatory issues to *MiFID* investment firms would be brought inside the scope of the directive. There is therefore a strong case for treating *commodity derivatives markets* differently from other financial services

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<sup>52</sup> 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](http://ec.europa.eu/internal_market/securities/isd/questions/index_en.htm)

<sup>53</sup> 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](http://ec.europa.eu/internal_market/securities/isd/questions/index_en.htm)

markets, and for modifying the exemptions in Articles 2(1)(i) and (k) rather than simply removing them.

215. CESR/CEBS believe that the exemptions should deal with the specific commodity-related concerns about the incidental provision of investment services and own-account trading.
216. In respect of the incidental provision of services, the intention would be to have an exemption which was available only to entities which were not otherwise providing investment or banking services. Such entities would be able to remain exempt from *MiFID* if they provide investment services in relation to *commodity derivatives* to someone with whom they have a business relationship and where the provision of the investment services is connected to the provision of other non-financial services. This exemption should be interpreted in a very narrow way.
217. In respect of own account dealing, the intention would be to have an exemption which enables entities trading on their own account as part of a primarily non-financial business to remain outside the scope of the Directive. The exemption should not be available to entities dealing with unsophisticated clients, or dealing on own account in order to execute client orders or who are otherwise providing investment or banking services.
218. It is not intended that this exemption for dealing on own account should mirror the proposal made by ISDA-EFET-FOA. CESR/CEBS believe that the proposal that has been made would potentially exempt some firms or activity currently within the scope of *MiFID*. CESR/CEBS do not believe that a case has been made for this. CESR/CEBS also do not accept that own-account trading between entities raises no issues of regulatory concern. Investor protection concerns are lower for this type of activity, but are not necessarily non-existent given that not all of the participants will be the equivalent of eligible counterparties under *MiFID*. Such trading may also raise issues of market confidence that require regulatory attention.
219. It is intended that it would be permissible to combine these new exemptions with the existing exemptions in the Directive. It would be helpful to make this intention clear in legislation, possibly through a recital.

## Part E. CRD/MiFID Q 5

### 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?

### I. Differences based on the type of entity

220. The sections on Market Failure Analysis and Regulatory Failure Analysis are the basis for the discussion in this Advice on whether the regulatory regime in *CRD* and *MiFID* should be altered for firms that specialise in

investment services related to *commodity derivatives* or for the provision of investment services related to *commodity derivatives*.

221. With respect to *CRD* the main arguments for or against differentiation are based on the perceived degree of systemic risk for *specialist commodity derivatives firms*. The reasons for this were explained in the market failure analysis in Part B.

222. However, CESR/CEBS believe that adaptation of *MiFID* (if any) should apply to all investment firms that provide investment services relating to *commodity derivatives* irrespective of the type of entity concerned.

## **II. Differences based on the underlying commodity, asset, right, service, or obligation**

223. The responses to CESR/CEBS's Call for Evidence included differing 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.

224. 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.

225. CESR/CEBS 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 express a view on the desirability of a specific regime for *electricity and gas* derivatives.

## **III. Different regulatory treatment for energy firms**

226. Question 5 of the Call for Advice specifically asks 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. CESR/CEBS examined 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 *energy* trading entity will not necessarily have recourse to such fixed assets.

227. The respondents to CESR/CEBS's consultation were mainly of the view that the similarities between the risks posed by *energy*-only firms and firms active in other *commodity markets* were greater than the differences. However, one respondent suggested that any regulatory regime proposed in relation to *commodity derivatives* should be tested against each market segment because of the heterogeneity of *commodity derivatives markets*.

### Conclusion

228. CESR/CEBS 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.

## Part F. CRD Questions 4 and 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?

#### Commission's 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:

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*

**1. The application of *CRD* large exposures and free deliveries treatment to commodities related transactions in the light of *commodity markets'* practices, and in particular, in the light of the shortcomings set out in Part C of the second part of CEBS's technical advice**

229. As requested by the Commission's Call for Advice, this section deals with *CRD* large exposure and free deliveries treatment as a stand-alone 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.
230. Note also that the exemption from the large exposure provisions does not affect private investors, as Article 45(1)(b) of *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.
231. 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, because of common usages in certain commodities markets, *commodity* trading is connected to high-volume credit exposures: free deliveries (as defined in Annex II, Section 2 of *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.
232. 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. Also 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.
233. Another reason for commonly incurred large exposures is that trading companies deliver commodities to the other members of the group the firm belongs to, but without cashing it in immediately. Since some *specialist commodity derivatives firms* do not have sufficient own funds compared to the

extent of such exposures, the claims of such firms against the members of their group regularly exceed large exposure limits.

234. In conclusion, full application of the large exposure rules would, given current usages in commodities markets, demand very significant amounts of capital for *specialist commodity derivatives firms*.

235. As explained in the market failure analysis in Part B CESR/CEBS are of the opinion that the activities of *specialist commodity derivatives firms* do not generate significant systemic concerns. Thus they conclude that the application of the *CRD* large exposures regime to *specialist commodity derivatives firms* appears disproportionate, and it would appear appropriate to adopt an approach comparable to that of Article 45 *CAD*.<sup>54</sup>

### **Additional Issues**

236. As regards the capital requirements for free deliveries, Annex II, Section 2 of *CAD* treats free deliveries as exposures during the time interval between delivery and due date of payment (regardless of the length of that interval). 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.

237. Article 106 of *Directive 2006/48/EC* provides that 'exposures' for the purposes of the 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. In the opinion of CESR/CEBS, accepting market practice in relation to deliveries is something which is transferable to commodities business, even though the settlement periods in the normal course of business are longer.<sup>55</sup>

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

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<sup>54</sup> As also explained in the market failure analysis in Part B BaFin, Commission Bancaire and Bank of Slovenia are of the opinion that it is not possible to conclude that the systemic concerns generated by *specialist commodity derivatives firms* are lower than those generated by *ISD investment firms*. Thus these members believe it is appropriate for *specialist commodity derivatives firms* to be subject to the application of the *CRD* large exposures regime.

<sup>55</sup> BaFin, Commission Bancaire and Bank of Slovenia do not believe that it is appropriate to compare the operation of Article 106 of *Directive 2006/48/EC* with practice in *commodity markets*. These members stress that this Article is limited to the ordinary course of settlement, which, in their opinion, refers to contracts where both the contractual payment leg and the contractual delivery leg are terminated on the same day, whereby a grace period of up to 5 days is accepted. Unlike this, it is typical for commodities business that the span of time between the contractual delivery leg and the contractual payment leg is contractually agreed from the outset, such that this situation is not comparable with a grace period. These members wish to stress that the extent of free deliveries during a period of up to 52 days between delivery leg and payment leg of a contract (resulting from common usages e.g. in some *energy* markets) could result in outstanding amounts which, from a prudential perspective, could cause a significant threat to the solvency of a firm in the case of default of its counterparty, as long as those parts of the exposures exceeding the large exposures limits are not sufficiently protected by own funds.

238. In response to questions 1 to 3 above, two general issues have been identified as sources of regulatory failure: (1) the fact the current regulatory situation in the EU 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 *CAD* applies, the second is still an issue for these market participants.

#### **a. Shortcomings in the maturity ladder approach**

239. As explained in Part C of the *second part of CEBS's technical advice*, the industry has raised concerns about 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 *CAD*. For the reasons given below, this approach does not appear to be suitable at least for 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.

240. 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.

241. 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.

242. The issue of static rates was also highlighted by comments on the Consultation Paper. Examples given referred to a strong backwardation of the term structure of volatilities for power and gas, such that the 15% outright

rate was deemed as too low for short term products and too high for long term products. The same comment expressed the opinion that the 3% spread rate could be too high for commodities such as metals whose maturity buckets are correlated.

243. As part of the maturity ladder approach, *physical positions* 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:

1. 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.
2. 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 at weekends and thus not a comparable delivery period. The Directive is silent on how to make this decision in calculating the average spot price.
3. 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 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.

244. 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 at a future date. It should also be considered to make them available for storable commodities since backwardation of prices like oil and metal could be distinctive. For the same reason, such an approach is also inappropriate for the market risk of *exotic derivatives*.
245. The industry has repeatedly pointed out that basing the maturity ladder approach on spot prices may (under certain circumstances) not be suitable for storable commodities, too. One example given refers to commodities such as oil and metal for which in periods with shortages in supply (as recently) the forward price curves for these products exhibit a strong backwardation, i.e. prices for short term products are much higher than for products at the long end of the price curve.
246. 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 derivatives* 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 could be applied to any type of *commodity derivatives*. It is still a standardised approach, since the only inputs required by the *institution* are the respective volumes for distinct delivery periods and the history of forward prices for each delivery period. Concrete examples of how this approach could be incorporated into *CAD* are given in the Annex to this report.
247. Comments on the Consultation Paper agreed that option 1 could, to a certain extent, solve the issue caused by applying spot prices to forward contracts, which has been considered to be the most important weakness of the maturity ladder approach. However, option 1 does not address other identified weaknesses with this approach.
248. With respect to option 2, one respondent has agreed that this alternative approach could be appropriate to mitigate the problem of overestimating risks. This respondent especially emphasised that this approach does not solely depend on current forward prices but instead derives forward prices from the history over a specified observation period. However,

other respondents expressed strong objections against this approach, since in their opinion this approach:

- does not consider correlations within a market risk portfolio;
- has a significant bias in comparison to a risk model, which is considered by these respondents to be adequate,
- mingles two different approaches, since a maximum value is added which is not part of a VaR risk model, and
- leads to significant costs for IT implementation when used in addition to a method considered by these respondents to be adequate for risk management.

249. Implicitly these respondents are saying that using an internal market risk model for calculating regulatory capital requirements is more suitable for better recognition of correlations and for risk management. CESR/CEBS believe that this could be the case and therefore are not recommending the historical forward price approach as a replacement for using own internal risk-management models to calculate regulatory capital requirements (Annex V of *CAD*), but as an additional standardised approach which should be available as an alternative to the maturity ladder approach.

250. For the purpose of a standardised approach it is, however, not recommended that firms be allowed to use their own estimates of correlations between different delivery/settlement dates. Especially, since spot prices for certain *commodities* (electricity, gas, and some soft commodities) and for *exotic derivatives* (e.g. climate) have a more or less strong seasonal structure (e.g. spot prices for electricity could typically be higher in winter than in summer, higher during the week than on weekends, and higher for peak hours than for off-peak hours, especially in the night). For such commodities, estimating correlations between different delivery/settlement periods requires a rather sophisticated reflection of the impacts of these seasonalities on the dependencies between movements of prices for different delivery periods. Where an *institution* would like to estimate such correlations, it should apply to use an internal market risk management model to calculate regulatory capital requirements.

251. With respect to IT implementation costs it should be noted that the historical forward price approach is still intended to be a standardised approach and as such avoids the qualitative requirements of using an internal market risk management model. Although higher implementation costs compared to the maturity ladder approach could occur, this approach still avoids the even higher implementation costs of complying with the qualitative requirements for using an internal market risk management model to calculate the regulatory capital requirements.

252. With respect to the criticism on mingling two different approaches, it should be noted that a standardised approach makes it necessary, from a prudential point of view, to include a sufficient degree of conservatism to ensure that potential losses are sufficiently covered by own funds. For this reason, the calculation of capital requirements has been based on the maximum accumulated change in market value of a market risk portfolio which has been observed for a certain trading day, plus a figure for the possible variation in such changes in market value of such a market risk

portfolio (based on a 99% confidence level and a holding period of 10 days and the assumption of normality for price returns). If an *institution* considers that referring to the maximum observed change in market value would be inappropriate for internal risk management, it would still remain possible for it to take into account the results of the historical VaR calculation.

253. Taking into account all comments received, CESR and CEBS recommend option 1 as a pragmatic solution for addressing the most important issue of the maturity ladder approach, but also recommend making available the historical forwards price approach (option 2) as an additional, more sophisticated standardised approach. These approaches should be available in relation to storable and non-storable *commodities* and their derivatives and also for *exotic derivatives*.

254. Any of these approaches include, depending on the degree of risk-awareness, a certain balance between implementation costs, on the one hand, and conservatism of regulatory capital requirements, on the other hand. Therefore, it could be left to the *institution* to choose between the maturity ladder approach based on forward prices and the historical forward price approach, if it wishes to apply a standardised approach, or to apply to use an internal market risk management model.

#### **b. Reporting requirements for ancillary agricultural commodities business**

255. The problem in this context is that reporting requirements for small amounts of physical commodities appear to place a disproportionate burden on 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 is taken.

256. 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.

257. 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 undertaken 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.

258. 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 to be appropriate.

259. Therefore, it was proposed in the Consultation Paper that the frequency for reporting (capital) requirements should be reduced from monthly to semi-

annual for ancillary agricultural commodities business below a certain threshold.

260. However, the industry pointed out in their comments on the Consultation Paper, that the proposed solution would not solve the problem, because, for the purposes of the calculation of capital requirements, credit institutions would still remain obliged to carry out inventories during the year. Therefore, the industry proposes that credit institutions with limited amounts of *commodity* risk should be exempted from the obligation to hold regulatory capital against that risk. The industry proposes a 500,000 EUR capital requirement as a reasonable threshold.

261. CESR/CEBS appreciated the comments from the industry and acknowledge that the sole relaxation of the reporting requirements would not solve the problem of burdensome inventories during the year. However, an approach to solve this problem, should in the view of the CESR/CEBS, not contain a general exemption from capital requirements for these specific risks. CESR/CEBS consider that a simplified approach for the reporting and calculation of capital requirements for ancillary agricultural commodities business could solve the problems mentioned above and still provide a meaningful prudential treatment for these risks.

262. What might such an approach look like? Firstly one would need to make sure that only credit institutions with ancillary agricultural commodities business could use it. This can be achieved by limiting the scope of such an approach to credit institutions with capital requirements for commodities business which do not exceed on average a certain threshold of their own funds during one year. Secondly there should also be a requirement, that the volatility of the *commodity* risk is limited to some extent, i.e. that peak capital requirements (above the average) for this risk do not exceed a certain level. This can be achieved by an additional provision which requires that peaks in capital requirements for *commodity* risks during a year should not exceed a certain percentage of the general threshold. Thirdly, a general threshold should ensure that the proposed treatment is only available for *commodity* holdings up to a certain limit. This threshold does not need to be extremely conservative because under such an approach credit institutions would be required to hold regulatory capital for the conservative average of their risks. Last but not least, it needs to ensure that credit institutions monitor factors which might influence the capital requirements for *commodity* risk and recalculate them if appropriate.

263. Therefore, CESR/CEBS propose giving credit institutions with ancillary agricultural commodities business the possibility of determining at the end of each year the regulatory capital requirements for their *commodity* risk which they have to hold for the following year. To be allowed to apply such a treatment a credit institution would have to be able to demonstrate to its competent authority that it meets the following conditions:

- a) at any time of the year it holds own funds for its *commodity* risk which are not lower than the average capital requirement for that risk estimated on a conservative basis for the coming year;
- b) it estimates on a conservative basis the expected volatility for the figure calculated under a); and

- c) its average capital requirements for *commodity* risk do not exceed 5% of its own funds or 1 Mio Euro and, taking into account the volatility estimated according to b), the expected peak capital requirements do not exceed 6.5% of its own funds.

264. Furthermore, a credit institution which uses such a simplified approach should report it to its competent authority and should be required to monitor on an ongoing basis whether the estimates carried out under a) and b) still reflect the reality. If, for example, significant changes in *commodity* prices or changes in the amount of commodities a credit institution has in its stock or other relevant issues have happened, the credit institution should be required to recalculate the figures under a) and b), taking into account the new information.

### **c. Further shortcomings in the Directive**

265. CESR/CEBS note that the definition of financial instruments in Annex I, Section C of *MIFID* is not entirely reflected in *CRD*. The following discrepancies have been identified:

***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 CAD***

266. These provisions contain the expressions '*commodity* risk' or '*commodities* risk'. Since for implementation of *MIFID* the definition of financial instruments includes '*exotic derivatives*' as well. It should be made clear in *CRD* that these provisions also apply to *exotic derivative* risk.

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

267. The scope of the second subparagraph of Part 3 is limited to "contracts related to commodities other than gold". Despite a reference to paragraph 3 of Annex IV it is not clear whether this also includes *exotic derivatives*. CESR/CEBS recommend revising the wording of this subparagraph to make clear that the treatment under the last column in Table 2 is also available for *exotic derivatives*.

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

268. 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."*

269. 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.

## II.CESR/CEBS's 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 derivatives* 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

270. 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).
271. 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

272. 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 *CAD* (capital requirements, large exposures, internal governance and risk management, disclosures, etc.) or *MiFID*, and to apply exemptions differently to certain commodities

273. 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.

#### **4. An appropriate prudential regime**

274. As mentioned above, there is no obvious answer to what constitutes an appropriate prudential regime for *specialist commodity derivatives firms*. But as mandated in the Commission's Call for Advice, CESR/CEBS describe below two options for a prudential regime for *specialist commodity derivatives firms* "for further study in terms of likely impacts (costs and benefits)".

##### **a. Options for a prudential regime for *specialist commodity derivatives firms***

###### **i. Option 1: adequate financial resources requirements and qualitative risk management**

275. One option would be an approach founded on a 'risk control and disclosure framework'. The main features of this approach are that:

1. individual *specialist commodity derivatives firms* would be able to choose to adopt the approach subject to the approval of their competent authority;
2. *specialist commodity derivatives firms* could also opt to apply the full *CRD* (full application would not include the large exposures regime and would include the previously suggested amendment to the maturity ladder approach);
3. the need for computing and holding regulatory capital would be based upon a high-level principle of 'adequate financial resources' rather than detailed rules as in *CRD* (this is similar to the Oil Market Participants (OMPs) regime that has been in operation in the United Kingdom for some twenty years);
4. firms would be required to meet the qualitative risk requirements contained in *CRD*;
5. firms would have to make an annual report to their competent authority which would include a breakdown of their financial resources, much as other *institutions* must assess their level of capital in the ICAAP;
6. firms would have to make public disclosures regarding risk management practices and risk exposures;
7. it would be open to supervisors to challenge a firm's calculation of what constituted an adequate level of financial resources in the light of the risks that it faced as part of normal supervisory activity;
8. competent authorities could remove authorisation to apply this approach from firms which were not able to demonstrate adequate

risk management policies, processes, arrangements and mechanisms and adequate financial resources; and

9. firms covered by this approach would be regarded as '*institutions*' under *CRD*.

## **ii. Option 2: Full application of *CRD***

276. The second option is to treat *specialist commodity derivatives firms* in general in the same way as other investment firms under *CRD* but with the inclusion of the amendments to the *CRD* for resolving identified shortcomings as set out in Part E, I, 1, Additional issues. The main features of this approach are:

1. *Specialist commodity derivatives firms* would have to operate at a level of own funds commensurate with their risks as determined for all *institutions* under *CRD*. Accordingly, the likelihood of their default will be limited to what is accepted under *CRD*.
2. However, where in the light of the aims of prudential regulation the burden of applying the *CRD* outweighs the impact of a potential failure of a firm (in terms of its impact on clients, counterparts and stability of the financial system), *specialist commodity derivatives firms* could under certain conditions be permitted to opt out from any prudential requirements, which could be achieved by excluding such firms from the definition of "investment firms" in Article 3(1) of *CAD*. The scope of such an option/exemption would need to be limited to "immaterial" cases which could be exempted without compromising the overall aims of prudential regulation. At this stage, no criteria have been specified to indicate which firms might benefit from such an option.
3. Any *specialist commodity derivatives firm* exempted from the application of *CRD* would not be treated as an *institution* according to Article 3(1)c of *CAD*. This implies in particular that when another *institution* has credit risk (including *CCR*) exposures outstanding with such a firm, it could not apply the preferential risk weights for exposures to *institutions* that are available under the standardised approach for credit risk.

## **b. Pros/cons/industry feedback**

### **i. Option 1**

277. Pros:

- a) no need to change market usages (e.g. adaptation of distribution contracts);
- b) works with the grain of existing best practice amongst *specialist commodity derivatives firms*;

- c) no new barriers to entry into *commodity derivatives* trading for *specialist commodity derivatives firms*;
- d) less risk of crowding out smaller niche players;
- e) less risk of relocation of *commodity derivatives* trading into non-EU jurisdictions; and
- f) as consequence of b)-d) no/less loss of market liquidity.

278. Cons:

- a) supervisors would be responsible for the prudential supervision without having available the whole range of supervisory instruments;
- b) firms are potentially less well capitalized under *CRD* than other *institutions* with comparable risks; and
- c) it would allow *specialist commodity derivatives firms* to be treated as *institutions* although these firms are potentially less well protected against risks than firms which are subject to *CRD* as credit institutions and *ISD investment firms*. This would, for example allow lower risk-weights to be applied under the Standardised approach for credit risk exposures (including *CCR* exposures) to these firms.

## **ii. Option 2**

279. Pros:

- a) firms are equally capitalized with other *institutions* under *CRD* that have comparable risks; and
- b) the full range of instruments (qualitative and quantitative structural norms, intervention opportunities etc.) necessary for taking on responsibility for prudential supervision of a firm is available.

280. Cons:

- a) potentially higher capital costs than under option 1;
- b) potential negative impacts on commodities and *commodity derivatives markets* including less liquidity on European markets and business moving out of the EU; and
- c) there is no clarity on how the exemption would operate and therefore how many *specialist commodity derivatives firms* would be subject to the *CRD*.

## **Feedback from the industry**

281. The responses to CESR/CEBS's Consultation Paper were opposed to the application of the full *CRD* to *specialist commodity derivatives firms*. The responses were supportive of an approach based on the principle that such firms should have 'adequate financial resources'.

## c. CESR/CEBS's positions

### i. Option 1

282. Option 1 is preferred by CESR/CEBS members from Czech National Bank, National Bank of Poland, Deutsche Bundesbank, Banco de Espana, De Nederlandsche Bank, Finansinspektionen (SE) and UK FSA who believe that this approach is the most appropriate based on the proposition that *specialist commodity derivatives firms* pose less systemic risk than credit institutions and *ISD investment firms*.
283. Designing a bespoke rules-based prudential regime for *specialist commodity derivatives firms* would be difficult given the heterogeneity of the firms covered. This is why it makes sense to have a regime which is tailored to the risks and structures of the firms concerned through the 'adequate financial resources' requirement. It also works with the grain of the existing treatment of such firms (building on best practice in risk management) and therefore would minimise any disruption arising out of the introduction of an EU prudential regime for such firms. In particular they should not be forced into structural changes in order to accommodate this approach to prudential regulation and the regime should not erect new barriers to entry into *commodity derivatives* trading or risk crowding out smaller niche players. This approach should also help to maintain the competitiveness of the EU as a location for the partially internationally mobile activity of *commodity derivatives* trading.
284. The CESR/CEBS members from BaFin, Commission Bancaire, Banco de Portugal and Bank of Slovenia raised concerns about allowing *specialist commodity derivatives firms* to apply a purely qualitative based prudential regime. They have doubts that under this approach relevant risks would be mitigated to an extent that the need for protection by own funds against unexpected losses would vanish. They stress that it is at least questionable how monitoring and management activities would protect against the sudden unexpected default of a counterparty or against being unable to close market risk positions at short notice in case of unexpected severe adverse price or spread movements. Against this background they consider it would not be appropriate to simply apply a high-level principle of 'adequate financial resources' rather than detailed rules as in the *CRD*. In particular, these members have concerns about basing a prudential regime on a firm's own definition of 'own funds' (i.e. on an individual definition of what kind of 'financial resources' are sufficiently able to absorb potential losses) and on a firm's own assessment of the amount of such 'financial resources' that would be necessary for covering the risks this firm is or might be exposed to. All in all, although these members agree with the necessity for adjustments for *commodity* products/markets as set out in Part F, I, 1. they stress that no evidence has been provided for the assumption that the application of the prudential regime in the *CRD* would generally not be proportionate for *specialist commodity derivatives firms*.

### ii. Option 2

285. Option 2 is backed by the CESR/CEBS members from BaFin, Banco de Portugal and Bank of Slovenia. These members see no evidence that the application of the prudential regime of the *CRD* would generally not be proportionate to the risks *specialist commodity derivatives firms* enter into. Commission Bancaire expressed the view that option 2, while being probably not appropriate for all the commodities firms, is more preferable than option 1.
286. These members consider it necessary in order to take on responsibility for prudential supervision of a firm that the full range of instruments (both qualitative and quantitative structural norms, intervention opportunities etc.) is available. They however stress that option 2 does also include abstaining from such responsibility in total, where exempting specialist commodity derivatives firms from prudential supervision would be immaterial for achieving the aims of prudential regulation.
287. They also argue that this option avoids creating a competitive advantage for *specialist commodity derivatives firms* over any credit institution or *ISD investment firm* engaged in the same business.<sup>56</sup>
288. The CESR/CEBS members from Czech National Bank, National Bank of Poland, Deutsche Bundesbank, Banco de Espana, De Nederlandsche Bank, Finansinspektionen (SE) and UK FSA have concerns about the full application of *CRD* to *specialist commodity derivatives firms*. They believe that such an approach does not take proper account of the systemic risks posed by *specialist commodity derivatives firms* and is therefore disproportionate. Moreover they believe that the full application of *CRD* to *specialist commodity derivatives firms* is likely to damage the EU's competitiveness as a location for trading in *commodity derivatives* and to raise barriers to entry in *commodity derivatives* trading within the EU.

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<sup>56</sup> 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."

## Annex

<b>ANNEX</b>	Historical forward price approach
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<b>Insert into Directive 2006/49/EC, Annex IV</b>
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### (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.