



Public hearing on Draft Advice on the review of commodities business

ComTF 2008 04

London, 4 September 2008

Outline

- Process so far
- Market failure analysis
- Regulatory failure analysis
- Advice on MiFID
- Advice on CRD

Process so far

- **December 2006:** European Commission's Call for Evidence
- **2006/2007:** separate Calls for Advice to CESR and CEBS
- **December 2007:** Joint Call for Advice to CESR and CEBS
- **15 May 2008:** CP 3L3 08 02 published
- **7 July 2008:** first public hearing
- **1 August 2008:** end of consultation period
 - 16 responses, 13 of which have been published on the CESR and CEBS websites

Market Failure Analysis - Questions

- Are the aims of market regulation hampered by information asymmetries?
- Are the aims of prudential regulation hampered by negative externalities?

Market Failure Analysis – Information asymmetries

- Market failure through information asymmetries and...
 - Failure to act in the client's best interest
 - Potential for significant market failures is limited
 - But: some market participants may have informational advantages by being active in both the commodity derivatives market and commodity production/supply
 - Market transparency
 - Concerns about information asymmetries result in particular from the significance of OTC commodity derivatives markets which are by nature less transparent than regulated markets
 - Responses to the CP indicate that these opacities in practice are no major issue for market participants

Market Failure Analysis – Information asymmetries

- Market failure through information asymmetries and...
 - Market abuse
 - Information asymmetries can result in abusive market conduct like insider dealing or market manipulation
 - But commodity derivatives are within the scope of the Market Abuse Directive

Market Failure Analysis – Negative externalities

Market failure through negative externalities

- Of regulatory concern if they have the potential to create a systemic risk
- Impact on Commodities Market
 - Firm failures can affect price and availability of commodities

Market Failure Analysis – Negative externalities

- Impact on Financial Markets – Types of firms
 - Specialist commodity derivative firm
 - Traditional focus on price optimization
 - Relatively low systemic relevance
 - Credit institutions
 - Central role in economy
 - High potential for cross-market contagion in case of difficulties/failure
 - ISD investment firms
 - Active in many financial markets
 - Growing role in clearance and settlement processes
 - High potential for cross-market contagion in case of difficulties/failure

Market Failure Analysis – Negative externalities

■ Conclusion

- Majority of ComTF thinks that systemic risk of specialist commodities firms appears to be relatively low compared to credit institutions and ISD investment firms
- This conclusion is shared by the respondents to the CP

Regulatory Failure Analysis – Questions

- Potential regulatory failures because of differences in regulatory treatment, in particular
 - significant competitive distortions
 - significant impairment of the free movement of services between Member States
 - regulatory arbitrage?
- Likelihood that such potential failures would be eradicated in the short or medium term as a natural consequence of market evolution, i.e. without regulatory/legislative intervention?

Regulatory Failure Analysis – Conclusions

- Majority of ComTF thinks that the full application of the CRD on specialist commodity derivatives firms would not be proportionate and could create a regulatory failure
- Need for convergence regarding the current patchwork of regulatory requirements across the EEA in order to avoid competitive distortions
- Ability of market to correct these issues in the short to medium term is unlikely
- Conclusions were confirmed by responses to CP

Potential shortcomings of MiFID and CRD – COM questions

- Does MiFID and CRD treatment of firms providing investment services relating to commodity derivatives and exotic derivatives continue to support the intended aims of market and prudential regulation?
- Does the analysis vary significantly depending on the type of entity providing the investment services or the underlying of the financial instrument?
- CESR's/CEBS's view on several [combinations of] options for the regulatory treatment of these firms

Advice regarding MiFID and CRD – MiFID Organisational Requirements and COB

- no evidence for need of an adaptation of MiFID's organisational requirements and transparency provisions
- change is suggested to enable firms to treat undertakings 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.
 - Accompanied by a similar transitional provision to that in Article 71(6) of MiFID if the exemptions are changed
- with an appropriate client categorisation regime *MiFID* conduct of business rules would not pose a particular problem for firms undertaking commodity derivatives business.

Advice regarding MiFID and CRD – MiFID definition of Financial Instruments

- The feedback on the CP provided no evidence that a clarification of the current definition is required

Advice regarding MiFID and CRD – Art. 2(1)(i) and (k) of the MiFID

- Articles 2(1)(i) and (k) should be replaced by the following exemptions:
 - persons providing investment services in commodity derivatives or derivative contracts included in Annex I, Section C 10 to the clients of their main business, provided this is an ancillary activity to their main business and that main business is not the provision of investment services within the meaning of this Directive or banking services under *Directive 2000/12/EC*; and
 - persons who deal on own account in commodity derivatives or derivative contracts included in Annex 1, Section C 10 exclusively under arrangements with authorised investment firms and equivalent third-country firms.

Advice regarding MiFID and CRD – Treatment according to type of entity or underlying

- No evidence that different treatment based on the type entity or underlying is appropriate
- No evidence that risks generated by energy-only investment firms differ materially from those posed by other specialist commodity derivative firms

Advice regarding MiFID and CRD – CRD LE and free deliveries regime

- LE regime of the CRD
 - Majority of ComTF considers full application to be disproportionate
 - would require significant amounts of capital
 - Activities of specialised commodity derivatives firms do not generate significant systemic concerns

Advice regarding MiFID and CRD – CRD LE and free deliveries regime

- Free deliveries
 - No need for adjustments of capital requirements
 - Rather extension of treatment as an exposure to a period that is more in line with market practices where payments are regularly made more than 5 days past due

Advice regarding MiFID and CRD – CRD Maturity ladder approach

- Not suitable for certain commodities as it may over- or underestimate capital requirements
- Possible alternative approaches:
 - Use of current forward price instead of spot price when calculating market risk charges
 - Develop approach not solely depending on current forward prices

Advice regarding MiFID and CRD – Ancillary agricultural commodities business

- Application of CRD requirements for frequent calculation of capital requirements would be overly burdensome
- Recommendation to provide a simplified approach for this kind of business

Regulatory options – Appropriate prudential regime

- Option 1: Adequate financial resources requirements and qualitative risk management
 - the need for computing and holding regulatory capital is based upon a high-level principle of 'adequate financial resources' rather than detailed rules as in *CRD*;
 - any firm using this methodology must meet the qualitative risk requirements contained in *CRD*;
 - a breakdown of a firm's financial resources would form a part of the annual report made by firms, much as full *CRD* firms must assess their level of capital in the ICAAP;
 - 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;

Regulatory options – Appropriate prudential regime

- Option 1 (contd)
 - the approach leverages existing and proven risk management practices rather than simply copying what the credit institutions do;
 - the approach leverages off the disclosure requirements from accounting (IFRS) and develops requirements which are relevant to the commodity industry;
 - *specialist commodity derivatives firms* could opt to apply the full CRD (It should be noted that the alternative approach would not eliminate the need for the adjustments for commodity products/markets set out in Part F, I, 1).;
 - 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
 - firms covered by this approach would be regarded as 'institutions' under *CRD*.

Regulatory options – Appropriate prudential regime

- Option 2: Full application of CRD
 - Full application of CRD, including Pillar 1 capital requirements and LE regime
 - Exemption for firms that are systemically not relevant
 - Exempted firms would not be treated as an institution according to Article 3(1)c of *CAD*.