

UK discussion paper on the Commission's review of the financial regulatory framework for commodity and exotic derivatives

December 2007



HM TREASURY





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EXECUTIVE SUMMARY

The European Commission (the Commission) is currently reviewing the financial regulatory framework for commodity and exotic derivatives (the Review). Due to report at the end of 2008, this Review could result in changes to the Capital Requirements Directive (CRD), the Markets in Financial Instruments Directive (MiFID) and potentially other directives. The Review is therefore complex in nature and could result in fundamental changes to the regulation of this business with associated risks and benefits for the UK commodity derivatives market. The purpose of this discussion paper is to ensure that the UK authorities – HM Treasury and Financial Services Authority (FSA) - are able to effectively reflect the views of the UK markets to the Commission during the course of the Review.

Commodity and exotic derivatives are an important, growing and innovative market. HM Treasury and FSA are conscious of ensuring any new regime continues to encourage this and retains the global competitiveness of these markets. Adherence to the better regulation principles and thorough market consultation will help ensure that any proposals take full account of these issues. HM Treasury and FSA commend the Commission's efforts to date in this regard and hope that this paper will further engage UK industry in the process.

A necessary justification for regulatory intervention is the existence of market failures. HM Treasury and FSA's analysis suggests that some form of regulation of commodity derivative business may be necessary but not to the same extent as for financial firms. This conclusion is echoed in the existing UK approach to regulation of these firms. Alongside the need for a proportionate approach, HM Treasury and FSA also see a need to tailor the regime to the specificities of the commodity and exotic derivatives market.

There are broadly three key policy areas.

- the limited retail participation means there is currently less need for conduct of business rules but the MiFID regime should offer a graded approach tailored to the needs of different market participants providing the status of the smaller 'professional' clients is recognised. HM Treasury and FSA see a case for altering the available MiFID exemptions to bring some additional business within scope but only if an appropriate capital regime were agreed. HM Treasury and FSA see no new evidence to justify altering the definition of MiFID instruments.
- HM Treasury and FSA suggest that an alternative regime is required to these firms' capital requirements and that changes to the CRD calculations for financial firms' activities in relation to commodity derivatives are also necessary. A bespoke regime may be merited for wholesale only players, in the energy markets and potentially more generally.
- HM Treasury and FSA see a particular need to adjust the transaction-reporting regime for commodity derivatives. However, no case has been made for new transparency requirements. Market abuse in the commodity derivatives market is already addressed by the Market Abuse Directive but HM Treasury and FSA see a case for considering whether more is necessary as part of the forthcoming EU Market Abuse Directive review.

The UK is a key centre for the trading of commodity derivatives both on-exchange and over-the-counter (OTC) accounting for some 14 per cent of worldwide OTC business. It is therefore particularly important for HM Treasury and FSA to draw on the experience of the UK regime and UK market participants as part of the engagement with the design of any new EU proposals. Responses are requested by March 2008. A summary of responses will be issued in Spring 2008.

INTRODUCTION

1.1 The Commission is reviewing the financial regulatory framework for commodity derivatives and 'exotic' derivatives.¹

1.2 Commodity and exotic derivatives are financial instruments - such as futures, options and swaps - that derive their value from the underlying commodity price and transfer commodity price risk from one party to another.² Commodity derivatives therefore provide a key mechanism for the management of commodity price risk, which should reduce the risk that commodity price volatility could pose to the wider economy. Commodity derivatives encompass a wide range of markets from the well established (oil derivatives) to the new (weather derivatives).

1.3 Financial activity in commodity and exotic derivatives markets is increasing in importance; there has been an increase in volumes traded, numbers and range of participants and the types of underlyings traded. For example, between 2004 and 2006 the notional value of outstanding over-the-counter (OTC) commodity derivatives increased almost five-fold to \$6.9 trillion.³ This has been coupled with a move towards increasingly homogenised packaging of products (e.g. commodity index funds and exchange traded funds/notes) thereby improving accessibility for financial investors, in particular retail clients.

1.4 This review is of particular significance to the UK as London is the largest centre for commodities trading after New York. The UK accounts for some 14 per cent of global OTC trading in commodity derivatives and hosts three major derivatives exchanges that account for 15 per cent of the global trade in commodities: London Metal Exchange, the main global exchange for non-ferrous metals; ICE Futures Europe, Europe's biggest exchange for energy products; and LIFFE, Europe's biggest exchange for soft commodities.⁴

1.5 Commodity and exotic derivatives business poses risks to market participants that are the same in nature (though not necessarily size) as the risks generated from other financial business, for example operational, credit, market and liquidity risks. Additionally, the risks to the broader economy in the event of the failure of a participant include not only disturbance to the financial markets but also potential dislocation of physical supply and demand.

1.6 Most firms trading in commodity derivative instruments have for a number of years been subject to both capital and conduct of business regulation in the UK. However, UK firms meeting the requirements of the UK's Oil and Energy Market regimes are subject to bespoke regimes that are considered more proportionate to their risks. The FSA does not regulate firms that are only active in the physical commodity markets and is not responsible for ensuring security of supply nor for protecting commodity consumers from price fluctuations.⁵

¹ Commodity derivatives are those financial instruments listed in Annex I, Section C(5), (6) and (7) of MiFID. Exotic derivatives are those financial instruments listed in Annex I, Section C(10) of MiFID.

² It has been a feature of the markets in primary commodities (such as coffee, copper, cotton, wool, rubber, tin) that imbalance between supply and demand gives rise to wide fluctuations in prices. For example, primary commodities often have long production cycles, which are difficult to adjust to bring into equilibrium with relatively short-run fluctuations in demand.

³ BIS Quarterly Review, March 2007.

⁴ International Financial Services Limited (2007): Derivatives 2007.

⁵ These roles fall to the physical commodity regulator - Ofgem in the UK for gas and electricity markets.

1.7 Through the Markets in Financial Instruments Directive (MiFID) the EU has recently extended EU regulation to recognise commodity derivatives as financial instruments, thereby regulating some specialist commodity derivative firms for the first time.⁶ Inclusion within MiFID is intended to further develop a single European market in these products. An effective, integrated commodity derivatives market would give institutions increased opportunities to access markets in other Member States as well as carrying out business effectively on a cross-border basis; and give consumers access to a wider range of more competitively priced products.⁷

1.8 However, the inclusion within MiFID is on a partial basis. There is still no comprehensive European framework for regulating commodity derivatives firms. So the Commission is conducting a regulatory review, the overarching objective for which can be summarised as:

*to facilitate a well-functioning, single market in commodity and exotic derivatives, whilst ensuring market stability, efficiency, integrity and investor protection, as well as enhancing the global competitiveness of EU firms, whilst keeping in mind level playing field issues between different market players, well-functioning commodity and commodity derivative markets contribute to security of supply.*⁸

1.9 The Review has to consider:

- which specialist and exotic commodity derivative firms should be covered by the MiFID regulatory regime;
- which commodity and exotic derivative contracts should be classified as financial instruments under MiFID;
- for those firms covered, to design the most appropriate prudential capital supervisory regime and conduct of business framework;
- whether to create a new category of energy investment firm; and the review
- may also consider broader market integrity issues in the commodity and exotic derivatives markets.

UK DISCUSSION PAPER

1.10 Given the significance of commodity and exotic derivatives markets in the UK and the UK's existing domestic regulation of commodity and exotic derivatives business, HM Treasury and FSA are keen to ensure that the UK experience and views are taken fully into account in the Commission's review. In April 2007, HM Treasury and FSA issued a joint letter responding to the Commission's Call for Evidence on commodity derivatives. The FSA additionally submitted a more detailed response to the Commission's individual questions. These, together with other responses, are available on the Commission's website.⁹

⁶ Specialist commodity derivatives firms are those firms that restrict their MiFID activities/services to commodity and exotic derivative financial instruments i.e. do not engage in wider investment activity in e.g. stocks and bonds. These firms tend to be active in the underlying product market.

⁷ http://www.hm-treasury.gov.uk/documents/financial_services/eu_financial_services/fin_euf_actionplan.cfm.

⁸ http://ec.europa.eu/internal_market/securities/docs/isd/call_for_evidence_on_commodities_en.pdf.

⁹ http://ec.europa.eu/internal_market/securities/isd/consultation/replies_derivatives_en.htm.

1.11 This paper revisits and builds upon those earlier responses. In particular it seeks to clarify UK objectives, examine policy options for addressing any perceived market failures and elicit stakeholder engagement. This will enable the UK to formulate its policy position and appropriately input into the Review.

1.12 The rest of the paper discusses the background to the review and its objectives; and provides an analysis of the current market structure, relevant market failures and the current UK regulatory regime. The paper concludes with a discussion of possible policy proposals. Those familiar with the review and current market regulation may prefer to focus on the latter sections. This paper will be of interest to all those active in the commodity derivatives sector and associated trade bodies, for example: specialist commodity derivative firms, banks and investment firms, exchanges, clearing houses, hedge funds, pension funds, lawyers, accountants and other consultants. Annex E comprises a list of those parties that HM Treasury and FSA have identified as potentially interested stakeholders. If you have suggestions of others who may wish to be involved in this process, please inform HMT or FSA (see contact details in Chapter 7).

BACKGROUND

2.1 Commodity and exotic derivatives were not recognised as financial instruments under the Investment Services Directive (ISD). However, financial firms are increasingly offering investment services based on such contracts. Consequently, MiFID extended the definition of financial instrument to include certain commodity derivatives and ‘exotic’ derivatives. This means that firms can benefit from the MiFID passport and this contributes to the development of a single market in commodity and exotic derivatives.

2.2 The HM Treasury and FSA view is that while bringing commodity and exotic derivative contracts within MiFID’s scope was justified in principle, the case for regulating certain specialist commodity derivative firms (i.e. those that restrict their MiFID activities/services to commodity and exotic derivative financial instruments) and the appropriate regulatory regime for such firms has not yet been clarified. It was accepted during the negotiations in MiFID and CRD that further investigation and analysis of these issues was required and a compromise was reached constituting:

- **a scope ‘carve out’.** MiFID exemptions remove some specialist commodity derivative firms from scope. These exemptions are ‘expected to exclude significant numbers of commercial producers and consumers of energy and other commodities, including energy suppliers, commodity merchants and their subsidiaries’;¹⁰
- **a capital ‘carve out’.** Art 48(1) of recast Capital Adequacy Directive provides a transitional exemption from the capital requirements of the Capital Requirements Directive for specialist commodity derivative firms who fall within the scope of MiFID; and
- **the Review.** In the medium term the Commission committed to conducting a thorough review of the financial regulatory framework applicable to commodity and exotic derivatives firms.

TERMS OF THE REVIEW

2.3 The legal requirements underpinning the Review require the Commission to examine four issues (set out in full in Annex A). However, the Commission has stated that it is minded to conduct a comprehensive review of the financial regulation of commodity derivatives firms and commodity derivatives business.¹¹ This means that along with scope and prudential issues, market transparency and market abuse issues may also be reviewed. While the scope of the immediate review is not yet finalised, the broader issues will be picked up in due course and hence HM Treasury and FSA are seeking industry views on the full range of issues set out below.

- **A review of scope of persons.** Some commodity derivative firms are exempted from the scope of MiFID and the Review should determine whether these exemptions remain appropriate and if not, what ‘proportionate [*regulatory*] requirements’ ought to be in place for

¹⁰ Recital 22 MiFID Implementing Regulation.

¹¹ The Commission’s Call for Evidence on Commodities.

commodity firms brought within MiFID scope. *Article 65(3)(a) and (b) of MiFID*

- **A review of scope of instruments.** The Commission is to re-examine the provisions relating to criteria for determining which OTC derivative contracts relating to commodities and exotic derivatives are to be treated as financial instruments for the purposes of MiFID. *Article 40(2) of the MiFID Implementing Regulation*
- **A review of capital requirements.** The Commission should report on 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 and exotic derivatives contracts.¹² *Article 48(2)(a) of the recast CAD*
- **A review of energy derivatives specific characteristics.** The Commission is to report on the desirability of amending MiFID to create a further category of investment firm whose main business consists exclusively of the provision of investment services or activities in relation to derivatives relating to energy supplies (including electricity, coal, gas and oil). *Article 48(2)(b) of the recast CAD*
- **Market transparency and transaction reporting.** Two units within the Commission have an interest in these issues. DG MARKT and DG TREN are proposing to issue a separate joint mandate to the Committee of European Securities Regulators (CESR) and the European Regulators' Group for Electricity and Gas (ERGEG) on transparency, record-keeping and transaction reporting issues.¹⁴ Consequently, this paper covers these issues.¹⁵
- **Market abuse.** The Commission is assessing 'the application of the Market Abuse Directive to commodity derivatives, exploring the desirability of further clarification of the regime or its extension'.¹⁶ The Commission has also asked CESR to examine rules on market manipulation and insider dealing within the EU in relation to commodity derivatives.¹⁷ Separately, a recent European Securities Markets Expert Group (ESME) report has identified some practical and definitional issues in the Market Abuse

¹² CRD legislates for three reviews: 1) the review of the financial regulatory framework applicable to the commodity and exotic derivatives sector; 2) large exposures; and 3) definition of capital (own funds). These are legislated for largely because they were considered too substantial to deal with in the course of the negotiations on the CRD itself.

¹³ CRD legislates for three reviews: 1) the review of the financial regulatory framework applicable to the commodity and exotic derivatives sector; 2) large exposures; and 3) definition of capital (own funds). These are legislated for largely because they were considered too substantial to deal with in the course of the negotiations on the CRD itself.

¹⁴ DG MARKT has invited 'comments on the transparency of commodity and exotic derivatives markets and on the appropriateness of the application of the transaction reporting regime'. Subsequently, another part of the Commission, DG TREN, as part of its Third Energy Package, published proposed new legislation that includes transparency proposals for the electricity and gas markets but leaves the issue of transaction reporting and disclosure of MiFID commodity financial instruments to be determined separately.

¹⁵ ERGEG was established by the European Commission in November 2003 by Decision 2003/796/EC. It is an Advisory Group of independent national regulatory authorities to assist the Commission in consolidating the Internal Market for electricity and gas. Its Members are the heads of the national energy regulatory authorities in the 27 Member States.

¹⁶ See Commission's feedback on the call for evidence.

¹⁷ See Point 5 in the Commission's initial call for assistance to CESR. 13 Mar 2007.

Directive (MAD) in relation to the commodity derivatives markets.¹⁸ Consequently, this paper covers these issues.

PROGRESS OF THE REVIEW TO DATE

2.4 So far the Review has encompassed a call for evidence by the Commission and preliminary advice from the Committee of European Banking Regulators (CEBS) and the Committee of European Securities Regulators (CESR). Key findings are noted below.

Key points from responses to the Commission's Call for Evidence (published 14th August 2007)¹⁹

- Many of the respondents favour maintaining the exemptions in MiFID and CAD and that the exemptions should be made binding.
- A sizeable minority of respondents is in favour of abolishing the exemptions and extending the MiFID and CRD regulatory regimes, possibly with some adaptations to accommodate commodity derivatives market specificities.
- Many respondents favour the clarification or modification of the Market Abuse Directive in order to improve the integrity of the markets and also mitigate any competitive distortions.
- There is broad consensus among stakeholders that 'doing nothing' is not a policy option that should be seriously considered. This is particularly the case in relation to the CAD where most respondents argue for a regime that is more adapted to the specificities of the commodity derivatives markets.

CEBS key findings (published 22 December 2006 and 10 October 2007)^{22 23}:

- The types of risk arising from commodities business and other financial markets (e.g. equity, interest rate) are generally the same.
- Most transactions are carried out OTC. Therefore, despite the use of risk mitigation techniques, significant counterparty credit risk remains and needs to be managed.
- Interconnections between commodity and exotic derivative markets and the wider financial markets can give rise to systemic risk concerns. However, their magnitude appears significantly smaller relative to the systemic risks posed by banks and investment firms. In the commodities case studies examined in the report, systemic concerns were limited and contained.
- The methods for calculating capital requirements in the CRD have some shortcomings in relation to the risks arising from commodities business. For

¹⁸ See Market Abuse EU legal framework and its implementation by member states: a first evaluation-July 2007.

¹⁹ http://ec.europa.eu/internal_market/securities/docs/isd/derivatives_en.pdf.

²⁰ <http://www.c-eps.org/Advice/advice.htm>.

²¹ http://www.c-eps.org/press/09102007_commodities.htm.

²² <http://www.c-eps.org/Advice/advice.htm>.

²³ http://www.c-eps.org/press/09102007_commodities.htm.

example, it is argued that it is not risk sensitive to use spot prices to calculate market risk charges on commodity forward/futures contracts.

CESR key findings (published 8 August 2007 and 22 October 2007)²⁶²⁷ :

- Overall, there is a high degree of consensus on implementing and interpreting the MiFID Article 2 commodity exemptions and Article 38 of the MiFID Implementing Regulation.
- There are some limited divergences in implementation; for example, does the dealing on own account limb of the Article 2(1)(i) exemption cover all MiFID financial instruments (the Commission's interpretation which the UK shares) or is it restricted to commodity derivatives (as some other Member States argue)? There are also differing interpretations as to the meaning of 'group' and whether company, banking or accounting laws/standards should determine this.

NEXT STEPS: EUROPEAN DIMENSION

2.5 A second joint call for advice will be issued shortly to CEBS and CESR. The Commission (or a consultant) will then, following the better regulation processes, do an impact assessment in early 2008. The Commission will produce its draft report in July 2008, a consultation period will then follow, with a final report being produced by December 2008.

The Commission's revised time-line

Mandates to:

ESME	December 2007
CEBS/CESR jointly	December 2007
CESR/ERGEG jointly (re 3rd Energy package)	December 2007
CESR/ERGEG report	May 2008
Impact assessment (by the Commission or by Consultant)	June 2008
ESME report	June 2008
CEBS/CESR report	July 2008
Commission draft report	July 2008
Consultation period	September 2008
Public hearing	September 2008
Final report	December 2008

NEXT STEPS: UK DIMENSION

2.6 The aim of this paper is to ensure that:

²⁴ http://ec.europa.eu/internal_market/securities/docs/isd/07-429_en.pdf.

²⁵ http://www.cesr.eu/index.php?page=document_details&from_title=Documents&id=4821.

²⁶ http://ec.europa.eu/internal_market/securities/docs/isd/07-429_en.pdf.

²⁷ http://www.cesr.eu/index.php?page=document_details&from_title=Documents&id=4821.

- UK industry is fully engaged in the review process; and
- officials are able to develop evidence-based UK negotiating policy objectives and positions.

2.7 These are complex issues and this is a discussion paper designed to encourage maximum input. Questions are posed throughout the paper. Wherever possible HM Treasury and FSA welcome clear factual or quantitative responses. Responses are requested by 14 March 2008. A summary of responses will be issued in Spring 2008. Officials will continue to liaise with industry throughout the Review. HM Treasury and FSA will consult should changes to UK legislation and FSA's Handbook be required following the Commission's work.

3

OBJECTIVES FOR THE REVIEW

3.1 The Commission's overarching objective for the review is summarised above. This paper separates the Commission's overarching objective into more specific UK objectives that can be used to assess and justify proposals.

- To promote market confidence, stability and efficiency by keeping the negative externalities associated with failures of specialist commodity derivative firms to an acceptable level.
- To provide proportionate levels of investor protection by ensuring market participants have adequate information and appropriate protections, including against market abuse.
- To maintain the global competitiveness of firms by ensuring the global attractiveness of the EU commodity and exotic derivatives sector.
- To facilitate competition between firms by avoiding unjustified differences in treatment between commodity and exotic derivatives market players.
- To promote a liquid single market in commodity and exotic derivatives by facilitating the growth of, and innovation in, emerging commodity markets.
- To promote a regime regulating commodity and exotic derivative firms that is: proportionate to the risks; outcomes-focused; senior management-focused; and is, where appropriate, principles-based.

Q1 – Do you agree that these are appropriate UK objectives for the review? If not, what objectives would you support?

3.2 Of course all proposals should also meet the better regulation principles.

- **Necessary** – any intervention in the commodity and exotic derivatives sector must be dependent on the identification of a market or regulatory failure.
- **Suitable and proportionate** – several policy options should be considered for addressing any perceived failure, which should include retaining the status quo and non-regulatory options. The policy option chosen must demonstrate a close and credible link to the objectives, satisfy a cost-benefit analysis and have regard to the international competitive position of the EU financial services industry.
- **Transparent** – should rules prove necessary, they should be sufficiently clear and transparent to achieve the objectives and allow them to be applied without incurring a disproportionate cost.
- **Consistent** – across sectors and jurisdictions, minimising opportunities for undesirable regulatory arbitrage or distortions in the single market and having due regard to the impact of any rules in this context.
- **Flexible and risk sensitive** – providing institutions with the opportunity to adopt the approaches most appropriate to their situation and to the sophistication of their risk management; and ensuring any actions do not unnecessarily impede innovation.

Q2 – Do you agree that the better regulation principles are appropriate and necessary for the Review?

4

MARKET FAILURE ANALYSIS

4.1 As noted in Chapter 3, in determining what action, if any, should be taken, the key starting point is to identify whether there are any market failures. This Chapter along with Annex C focuses on understanding the UK commodity derivatives markets and associated market failures.

THE UK COMMODITY DERIVATIVES MARKET

4.2 Commodity derivatives markets are varied and complex. Some key features are considered below. These are further explored in Annex C.

Products **4.3** The largest markets in the commodity sector are oil, metals and agricultural products but growing markets include emissions and consumable energy derivatives.²⁸ Some of these markets are global such as crude oil, others are regional such as electricity and some are still highly fragmented such as the market in plastic derivatives. One useful measure of the relative size of a derivatives market is the ratio of derivative transactions to physical production or physical transactions. For gold, copper and aluminium, the volume of exchange-traded derivatives was around 30 times larger than physical production in 2005.²⁹

Trading venues **4.4** The market in commodity derivatives has been dominated by OTC trading, with OTC agreements representing an estimated 85 per cent of the notional value of outstanding commodity derivatives. London is a major centre for OTC trading of commodity derivatives, with an estimated 14 per cent of the global market share. Although OTC markets may dominate, exchange trading of commodities has also expanded rapidly over recent years. Again, London plays a leading role, with 15 per cent of the global market and three major derivatives exchanges: the London Metal Exchange, ICE Futures Europe and LIFFE. Multilateral Trading Facilities (MTFs) have also gained in importance in several financial markets around the world as an alternative to traditional exchanges, or as a complement to voice broking and bilateral OTC trading. In the UK there are several commodity derivative MTFs such as Spectron, ICAP, GFI, Prebon, TFS and Global Coal.³¹

Participants **4.5** Hedgers have traditionally constituted the most active force in the market, using commodity derivatives to protect their business – whether as producer or buyer – from changes in the price of the underlying commodity. Approximately a third of FSA regulated firms participating in the UK market are own account traders representing major oil or energy corporations. In recent years, however, there has been a marked change, as more private and institutional investors, including hedge funds, have sought financial returns through greater investment in commodities.

4.6 There is very little evidence of direct retail investment in the UK commodity derivative market e.g. a recent FSA survey revealed ‘the unanimous view is that there is hardly any retail investment’.³² This may be explained by minimum contract sizes e.g.

²⁸ Consumable energy products include gas and power but exclude oil.

²⁹ Bank for International Settlements (2007): Financial investors and commodity markets, http://www.bis.org/publ/qtrpdf/r_qt0703g.pdf

³⁰ International Financial Services Limited (2006): Commodities Trading.

³¹ International Financial Services Limited (2006): Commodities Trading.

³² FSA Occasional Paper, Growth in commodity investment: risks and challenges for commodity market participants, March 2007.

until recently, the smallest tradable contract size of copper on the LME was worth about USD 170,000. Consequently, traditionally only very wealthy retail investors have had sufficient assets to manage a portfolio of commodity derivative instruments. However, the market is becoming more accessible to retail investors as they can limit their risk and reduce transaction costs by investing in professionally managed commodity derivative funds. In recent years, products such as Exchange Traded Funds (ETF), Exchange Traded Notes (ETN), Exchange Traded Commodities (ETC) and structured notes have been developed for commodities.

4.7 Retail exposure to commodities also arises indirectly through pension funds. While in the UK, pension funds have been slower in investing in commodity derivatives, it is a popular form of investment in the US and Netherlands. For example, the Dutch Civil Service pension fund (ABP) has 2.7 per cent invested in commodities.³³

ANALYSIS OF MARKET FAILURES IN THE COMMODITY DERIVATIVES MARKETS

4.8 In a perfectly efficient market, firms produce at the lowest possible cost, in terms of resources used, and consumers buy the products they want at the minimum possible price, at which supply and demand are in balance. However, markets often deviate from this ideal. This Chapter therefore analyses market failures in commodity derivative markets.

4.9 Market failures may arise from the existence of: negative externalities; information asymmetries; or market power.

- **Negative externalities** are present if the production or consumption of a good or service has negative effects on the welfare of unrelated third parties that are not reflected in market prices. Of particular relevance is the concern that the failures of financial firms may have negative externalities on other market participants. Depending on severity, these can be characterised either as systemic or as non-systemic risks. Systemic risks represent a significant challenge to the HM Treasury and FSA objective of maintaining financial stability and market confidence.
- **Information asymmetries** arise when at least one party to a transaction has relevant information that the other(s) lacks. 'Relevant' means that the information could change the behaviour of the other party. Of particular concern is when information asymmetries result in mis-selling or market abuse. Information asymmetries may threaten the HM Treasury and FSA consumer protection and market confidence objectives.
- **Market power** is exercised when firms persistently raise prices above the level that would be achieved in a competitive market. Department of Business Enterprise and Regulatory Reform (BERR) and Office of Fair Trading (OFT) are responsible for competition issues. As market power concerns are not the direct focus of the Review, they will not be discussed further in this analysis but the impact on competition will, of course, be taken into account when considering policy options.

³³ Financial Services Authority (2007): Growth in commodity investment: risks and challenges for commodity market participants.

NEGATIVE EXTERNALITIES

4.10 Systemic risk is the possibility that the failure of a firm or firms threatens the stability of the financial system as a whole. 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). Whilst traditionally systemic risk concerns have focused on the banking sector, some non-bank financial institutions are so large and have such cross-sector interdependencies that their failure might lead to systemic consequences.

Impact on financial markets

4.11 Specialist commodity trading firms trade commodities with financial institutions and also purchase (directly or indirectly) financial services from financial institutions, including credit risk mitigation products such as Credit Default Swaps (CDS) or letters of credit. Accordingly, the failure of a firm trading in the commodities markets can affect other financial players and other financial markets.

4.12 However, so far there have been no cases where interconnections between commodity derivative firms and other financial firms have led to financial instability. This reflects the different position commodity derivative firms occupy within the financial system compared to other financial institutions. For example, banks play a pivotal role in the economy, accepting retail deposits, managing the payment system and providing finance for a large number of borrowers. Investment firms are active across numerous financial markets resulting in extensive cross-firm and cross-sector exposures. So the wider interconnections displayed by both banks and investment firms may result in cross-market contagion in the event of difficulties. By contrast, the failure of a specialist commodity derivative firm in its capacity as a trader of a certain class of derivatives will have more limited repercussions in wider financial markets.

4.13 For example, the collapse of the hedge fund Amaranth in September 2006 did not raise substantial systemic stability concerns. Similarly, problems at Sumitomo, Metallgesellschaft or indeed any other individual investment firm participating in commodity derivatives markets do not appear to have threatened systemic stability. However, these markets do present the risk of sizeable losses – indeed various brokers incurred significant losses in the Sumitomo event. Where a firm's failure does not lead to a systemic crisis, it may nonetheless have a negative impact on market confidence.

Impact on underlying markets

4.14 Many specialist commodity derivatives firms also produce or supply commodities. They tend to trade primarily in order to manage their natural long or short positions in certain commodities. The failure of such firms could, in addition to credit losses to their counterparts, affect the price and availability of commodities. This could also have implications for related markets, for example, for products requiring certain commodity inputs.

4.15 However, several large bankruptcies in the energy trading markets, including Enron, Transworld Oil and Gatt Oil, had only a limited effect on the energy industry. This may be because 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. Nevertheless, failure can have a significant impact – it has been estimated that Amaranth's alleged abusive trading resulted in an

\$18bn increase in consumers' energy prices. Security of supply is traditionally the focus of physical regulators such as Ofgem.

Conclusion 4.16 Although connections do exist between specialist commodity derivative firms and the wider financial markets, systemic risks generated by these firms appear to be generally lower relative to systemic risks generated by financial firms. This suggests that the negative externalities traditionally addressed by prudential regulation are less marked for commodity firms than for financial firms.

Q3 – Do you agree that specialist commodity derivative firms generally pose limited risk to the financial system? If not, why and can you provide evidence to support this?

2. INFORMATION ASYMMETRIES

4.17 Asymmetric information describes the situation where one group of market participants has more or better information than another and the former group has incentives to exploit that advantage to the detriment of the latter. Three types of information asymmetry are described below. Each information asymmetry could in turn crystallise into the following corresponding problems: mis-selling; poor levels of market transparency; and market abuse.

Information Asymmetries And Mis-selling

4.18 Most participants in the commodity derivatives markets are financial services firms and firms active in the underlying market. Information asymmetries between these firms are less marked relative to retail firms as these firms generally have the incentives and resources to seek out information. This suggests that significant market failures due to information asymmetries between wholesale firms are limited. However, this assumes that firms will be able to actually find that information. This is discussed further in the transparency section.

4.19 However, as is the case with other financial markets, information asymmetries between firms and their clients are more marked with retail clients than with wholesale clients. Retail investors are unlikely to seek out sufficient information and commodity derivative contracts are usually complex, making it difficult for (unsophisticated) investors to understand or evaluate information related to these contracts. Although, direct retail investors are currently few, they may increase in the next few years as professionals are devising products to attract retail investors. If such business did emerge, the safeguards established by MiFID would be necessary to protect the retail sector.

4.20 The current limited direct retail investment involvement 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 retail investors. For example, only very wealthy retail investors would have sufficient assets to manage a diversified portfolio of commodity derivative instruments for themselves given the size of most underlying contracts. Retail investors 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), Exchange Traded Notes (ETN) and Exchange Traded Commodities (ETC). These are available to retail

investors through brokers and banks, which are already regulated and hence consumers already receive the benefits of MiFID.³⁴

Conclusion 4.21 Evidence suggests that significant market failures due to information asymmetries between market participants in commodity derivative markets are limited. Although there are likely to be greater information asymmetries when retail clients are involved, their direct participation in this sector is currently very limited.

Information Asymmetries And Market Transparency

4.22 Participants in the commodity derivatives markets might be subject to information asymmetries if there are structural impediments preventing certain firms from accessing certain types of underlying information or if externalities mean that dealers publish less trade information than is optimal for the market as a whole as they may not consider the benefits this will create for market participants other than themselves. There are two key types of relevant information: information on trades in the derivatives markets; and information on the underlying markets (including on physical contracts). Both are discussed below.

Derivatives 4.23 At the shorter-term, more commoditised end of the derivatives market, business is often on exchange and hence transparency standards are high. Trading on MTFs is also generally transparent and market data is also available via commercial data services such as Bloomberg and Reuters. OTC markets remain less transparent but the more sophisticated players are not deterred from participating in these. Consensus pricing tools also increase information without the risks of full transparency.

4.24 Complaints about a lack of transparency by market participants can be a sign of a market failure. However, discussions with market participants suggest that most large participants do not have any significant issues with transparency in commodity derivatives markets.

Physical 4.25 Those organisations active in the underlying markets (e.g. oil and energy producers) as well as the derivatives markets have informational advantages over other participants in the derivatives markets. This can be viewed as a natural economic 'rent' accruing to those firms that have invested in the underlying commodity market and indeed many financial firms are seeking to, or have entered the underlying markets for that reason. There are no financial regulatory barriers to so doing, though the scale of investment required may deter some smaller financial firms. The information gained from the physical market may be important but participation in these markets entails risks. Distribution of some information from these markets is governed by the physical regulators, such as Ofgem. Recent EU proposals would also increase transparency of the physical gas and electricity markets.

4.26 Market participants in the commodity derivative markets have emphasised the importance of an understanding of the structure and operation of the underlying markets in order to be able to use the derivatives markets properly. Keeping abreast of the latest developments that would move the markets would be an important factor, including, for example, macroeconomic data on the effect of Chinese growth rates on the demand for copper or information on capacity constraints of the European gas pipeline networks. Without that broad market understanding and knowledge, greater transparency in the derivatives markets would make little sense. Initial discussions with

³⁴ FSA, 2007, Growth in Commodity Investment: Risks and Challenges for Commodity Participants.

market participants did not indicate that there was anyway in which changes to derivatives transparency could be employed to 'backfill' a lack of such knowledge.

Conclusion 4.27 There is limited evidence to date of a lack of transparency in the commodity derivatives markets.

Information Asymmetries And Market Abuse

4.28 Information asymmetries may also result in market abuse which can take the form of either insider dealing or market manipulation. Market abuse can lead to a loss of market confidence and disrupt the efficient functioning of the market. This will tend to increase the risk premium (returns) demanded by investors for continued market participation and reduce investment.

4.29 The risks of improper conduct in commodity derivative markets are similar to those in other financial markets. However, there are some specific issues in commodity derivatives markets related to the interplay between the commodity derivatives market and the market in the underlying commodity. This paper explores this further by analysing insider trading and market manipulation issues.

4.30 Insider trading involves a market participant trading on information in breach of a fiduciary obligation, or when the information traded upon has been misappropriated. However, commodity derivatives markets are slightly different to other markets as to what constitutes inside information. Many producers of commodities engage in derivative transactions, mostly for hedging purposes. These producers may have information from the underlying commodity market, which is price sensitive on the commodity derivatives market. Derivatives trading based on the knowledge of the physical market should not generally be regarded as inappropriate use of information. These issues are reflected in the different definition of inside information for commodity derivatives in the Market Abuse Directive, which is incorporated in Article 118C (3) of Financial Services and Markets Act 2000 (FSMA).

4.31 Another possible problem is that of market manipulation – i.e. market participants deliberately attempting to profit by undertaking trades or spreading misinformation which create a false impression of true supply and demand conditions. A specific market manipulation issue relates to the interplay between the commodity derivatives market and the market in the underlying commodity: a manipulator can 'corner' and 'squeeze' the commodity market. This creates market power and allows him to raise prices to his advantage.

4.32 When 'cornering' a market, a manipulator builds up large positions in the underlying commodities market in order to create an artificial shortage. This is usually done in conjunction with long positions in the forward/futures market. The manipulator will then demand delivery of the commodity (i.e. squeeze the market). As he simultaneously withholds his stock of supply, the sellers of the future will find it hard to acquire enough of the commodity to fulfil their contracts. The manipulator can then use his market power on the commodity market and charge high prices for his stock of the commodity.

4.33 There have been recent high-profile cases alleging market abuse in the commodity derivative sector. For example, BP America has entered a deferred prosecution agreement with the US Justice Department under which the company admits that it manipulated the price of February 2004 TET physical propane and attempted to manipulate the price of TET propane in April 2003. The Commodity

Futures Trading Commission (CFTC) Order settling the charges against BP Products, North America Inc found that employees of that company cornered the TET propane market for the purpose of dictating prices to other market participants in order to obtain a significant trading profit. Although this allegation raises market integrity concerns, these appear to be isolated occurrences rather than evidence of widespread market practices. In addition, had such activity occurred on an EU regulated market then it would likely have infringed the requirements of the Market Abuse Directive.

Conclusion 4.34 Commodity derivative markets are no less susceptible to improper conduct than other financial markets.

Q4 – Do you agree that there are information asymmetries leading to mis-selling concerns in commodity derivative markets ? If not, why and can you provide evidence to support this?

Q5 – Do you have any evidence of information asymmetries in relation to market transparency?

Q6 – Do you have any evidence of information asymmetries in relation to market abuse ?

Overall MFA conclusions

Negative externalities: systemic risks generated by specialist commodity derivative firms appear to be generally lower relative to financial firms.

Mis-selling: evidence suggests that significant market failures due to information asymmetries between wholesale firms are limited. Although there are likely to be greater information asymmetries when retail clients are involved, their direct participation in the commodity derivative sector is currently very limited.

Market transparency: there is limited evidence to date of a lack of transparency in commodity derivatives markets.

Market abuse: commodity derivative markets are no less susceptible to improper conduct than other financial markets.

5

UK FINANCIAL REGULATORY REGIME

5.1 Before considering how a new EU regulatory regime might best address these market failures, it is worth reflecting on the regulatory regime that has been applied to the UK's sizeable commodity derivatives markets for some 20 years.

PRE-MIFID

5.2 Before MiFID was implemented, FSA regulated many specialist commodity derivative firms. Approximately one third of these were subject to standard FSA conduct of business and capital requirements. However, for the remaining two thirds of these firms, FSA operated bespoke oil and energy market regimes (OMP and EMP regimes). These bespoke regimes covered, broadly speaking, firms that restricted their investment activity to oil and energy derivatives and did not deal with retail clients and/or individuals (see Annex B for elaboration). Banks and investment firms also carried out commodity derivatives business but only accounted for about 40 per cent of the total regulated commodity population. These firms were subject to the standard regulatory regime.

POST-MIFID

5.3 MiFID covers approximately 75 per cent of FSA-regulated firms that engage in commodity derivative activity. The remaining 25 per cent are Oil and Energy Market participants falling within a MiFID exemption. Of those firms falling with MiFID, approximately 35 per cent benefit from the CRD capital exemption; however, these firms remain subject to UK capital requirements (unless they are an OMP or an EMP with a capital waiver). The UK's regulatory net is therefore wider in the UK than required by MiFID and CRD. The UK decided to maintain its current regime pending the outcome of the Review.

Figure 1: FSA-authorized firms engaging in commodity derivative activities/services

MiFID exempt 21	OMPs 13	
	EMPs 7	
	Others 1	
Within MiFID 58	applying CRD 38	Banks 13
		Investment firms 21
		Commodities firms 4
	exempt from CRD 20	OMPs 3
		EMPs 3
		Specialists 14
NB some of the figures are based on estimates		

LESSONS FROM THE UK REGIME

Capital requirements **5.4** Capital requirements have applied to specialist commodity derivatives firms since 1988. However, it was clear that some of these firms posed a lower level of systemic risk relative to banks and investment firms active in wider financial markets. Therefore, at the time the UK introduced a bespoke regime for oil market participants. It was then accepted that risks posed by energy market firms were also lower relative to banks and financial firms so in 2001 a bespoke regime was introduced to allow energy market participants to take advantage of a capital waiver and give them equivalent treatment to oil market participants when certain conditions are met.

5.5 Those commodity firms subject to the ‘full’ level of UK regulation are those that do not meet the OMP/EMP criteria because they deal with retail clients/individuals or engage in financial activities/services in relation to commodities other than oil or energy. The UK regulatory system may have supported firms where there have been problems (some Enron subsidiaries that survived were UK regulated), but it is not clear that that is a proportionate justification for applying the full weight of CRD to specialist commodity firms.

Conduct of business **5.6** The UK regime also applied conduct of business requirements to specialist commodity derivatives firms and to a lesser extent to OMP/EMPs. This reflects the UK’s desire to provide the appropriate degree of protection to consumers. In practice most clients of specialist commodity firms were classified as intermediate customers or market counterparties. This meant that clients could opt out of many protections or protections did not apply. HM Treasury and FSA continue to see the application of a differentiated conduct of business regime as beneficial providing the professional nature of the commodity derivative markets is not frustrated by inappropriate delineation between professional and retail clients.

Specialist energy regime **5.7** The OMP and EMP regimes provide a less onerous capital and conduct of business approach but any potential risks are managed by strictly limiting which firms can qualify for these regimes. The most important requirement in practice is that they must limit their designated investment business to energy/oil market activity that is restricted to:

- not dealing with retail/individual clients; or
- the execution of own account transactions on any recognised or designated investment exchange (which will have their own risk management regimes); or that
- they establish, operate or wind up energy/oil collective investment schemes in which retail/individual clients do not participate.

5.8 Nevertheless, it was felt that some oversight of such specialist firms was necessary. Therefore, they remain subject to FSA’s high level Principles for Businesses, Senior management arrangements, Systems and Controls and Threshold Conditions. So although an OMP may have no Pillar 1 capital requirements under the CRD it must nevertheless have adequate, including financial, resources.

5.9 The bespoke regime is currently limited to oil and energy firms. These firms account for the majority of specialist players in the UK. However, it is timely to consider whether such a regime could be extended to specialist firms dealing in products other than energy derivatives. Indeed, it is likely that the key risk mitigant for these regimes is the restrictions on dealing, rather than the nature of the market. Moreover there are

limited clear differences between the oil and energy markets and other product markets.

- **Mix of participants** – while energy markets do contain large numbers of specialist firms dealing purely with fellow professionals – this is not unique to energy markets. Indeed some of the energy markets (e.g. emissions) may have a wider range of participants than other markets, such as metals.
- **Retail exposure** – it is a central theme of the UK OMP and EMP regimes that such firms are prohibited from dealing with retail clients and/or individuals. While direct retail involvement in energy markets remains limited, more accessible retail products have been developed. Moreover retail participation is also very limited in other commodity markets.
- **Nature of the risks** – there is no real difference in the risk types between commodity derivative classes.
- **Nature of the firms** – energy-producing firms will have large amounts of fixed assets that provide a measure of comfort, regardless of the absence of capital requirements. However, it is not necessarily the case that all specialist energy players will have fixed assets and indeed firms in other markets may have such fixed assets.

5.10 The developing nature of the markets suggests that the differences between energy products and other instruments may have become less marked. Therefore, a more general wholesale regime may have some merit. HM Treasury and FSA would be interested in industry views on the need for such an extension.

Q7 – Do you see benefit in retaining a bespoke regime for energy firms? If not, why not?

Q8 – Do you see a case for extending it to become a wholesale only regime? If not, why not?

Level Playing field **5.11** The current UK approach of different regulatory requirements means there are not identical regimes for firms carrying out the same activities. HM Treasury and FSA’s usual approach is equal treatment for equal risk – but this needs to encompass not just the cause but also the impact of the risk. As discussed above, there are good reasons why different treatment of some firms may be appropriate.

5.12 The different approaches in the UK have not appeared to result in commercial distortions. And indeed if there are commercial differences, these may be attributable to factors other than regulation – for example those active in the physical market are widely perceived as having informational advantages over other players – and many financial firms are entering the physical market for this reason.

5.13 An ‘unlevel’ playing field might additionally be tolerated if it enabled a wider range of firms to participate in the market on tailored rules. Many of these markets can be thin and reduced numbers of participants might be a concern for liquidity. However while there has been some increase in participation it is unclear whether that has delivered material benefits. For example, entry is often at the short end of the market (easiest to enter but already liquid); moreover such firms may not be committed liquidity providers in times of market stress.

Q9 – Do you agree that different rules in UK have not produced commercial distortions? If not, why and can you provide evidence to support this?

Instruments 5.14 The UK regime is slightly broader in instrument coverage than MiFID in two respects.

- It covers all physically-settled options on palladium, platinum, gold or silver. Only certain types of physically settled OTC derivative instruments (including options) fall with the scope of MiFID.
- Physically-settled futures are regulated in the UK where a contract is deemed to be for ‘investment purposes’. It is conceivable, although unlikely, that a physically-settled contract which does not meet the requirements of paragraphs 5,6,7 or 10 of Section C of Annex 1 to MiFID would be regarded as being for investment purposes.

5.15 The current scope of regulation of options on precious metals reflects the prominence of the London-based bullion market. Firms have not expressed a strong preference for enabling these products to benefit from the MiFID passport.

Q10 – Is the UK instrument boundary appropriate? If not, why and can you provide evidence to support this?

Transparency 5.16 The UK regime has not involved OTC transparency for commodity derivatives and MiFID does not change this. Trading on exchange, or via an MTF, is subject to transparency rules set by the exchanges or regulators. For instance, in the UK, it is necessary before a contract is traded on an exchange for a view to be taken that there is sufficient information available regarding the underlying markets to enable participants to make reasonably informed decisions about the associated derivatives.

Q11 – Is the UK approach to transparency appropriate? If not, why and can you provide evidence to support this?

Transaction reporting 5.17 Before MiFID, frontline monitoring of the commodity markets in the UK was conducted by the relevant exchanges. The exchanges collate position reports that provide a breakdown by named users of all positions across their markets held by members and their clients. Position reports allow the exchanges to aggregate exposures and calculate the overall interests of each user, irrespective of the number of firms through which they deal.

5.18 Analysing position reports enables the exchanges to assess overall interests by users and the resulting market impact. Any specific suspicions the exchanges may have of market abuse are referred to FSA for investigation. Position reports are therefore the key tool in the identification of potential market abuse.

5.19 However, under MiFID, reports of transactions in commodities fall to be made and, as appropriate exchanged between regulators in the same manner as transactions in other financial instruments. Reflecting concerns about the practicalities of this, CESR has agreed a pragmatic solution whereby the home competent authority of a commodities/forex/interest rate derivative market receives transaction reports directly from that market on behalf of all the other competent authorities. Instead of automatically exchanging those reports, the authority of the market would store the

data and respond on an ad hoc basis to requests for transaction reports from other CESR members. Firms will not have to report transactions in these products to their regulators.

5.20 HM Treasury and FSA do not believe that the benefits of applying the transaction-reporting framework to commodity derivatives outweigh the costs. In particular, transaction reports have little material benefit as the main form of abuse in these markets arises through market manipulation rather than insider dealing. Hence the reliance on position reports.

Q12 – Does the CESR compromise to MiFID transaction reporting address your concerns? If not, why and can you provide evidence to support this?

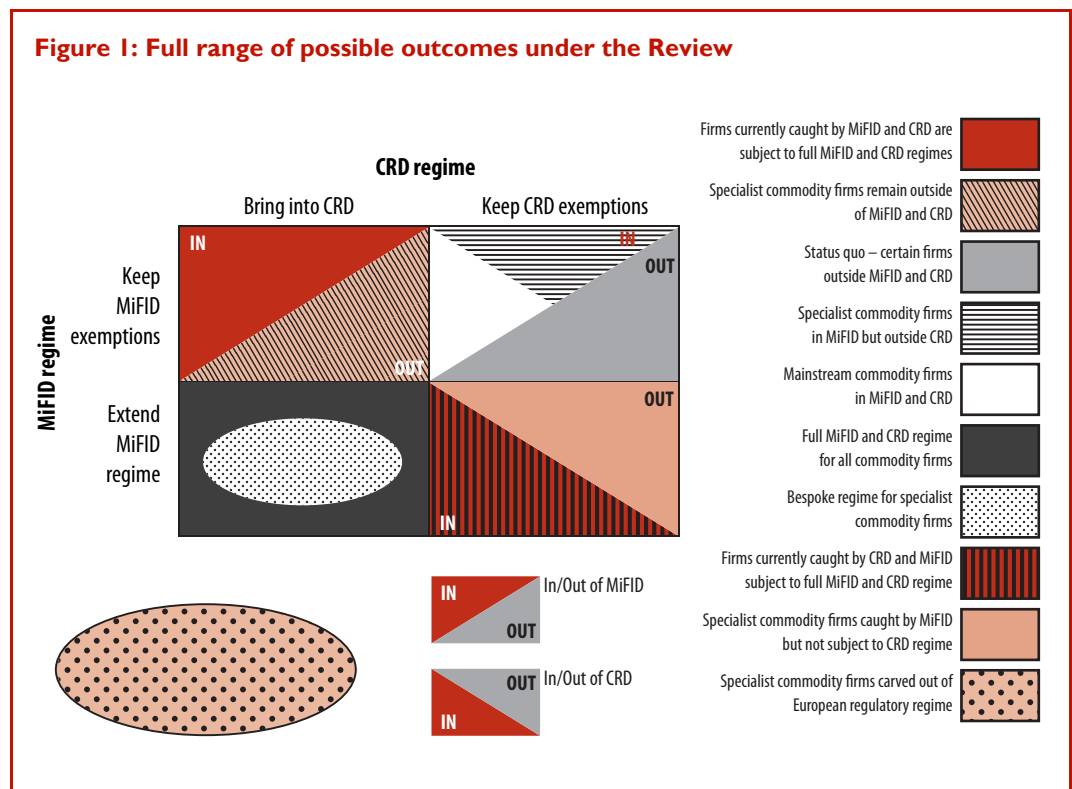
Summary 5.21 Overall, the UK regime has demonstrated that a bespoke approach to regulation of specialists can provide an effective regulatory regime. The tailoring of capital and conduct of business rules to specialist commodity firms has delivered appropriate client and market protections while allowing the market to grow and innovate. This balance is achieved through an important design feature that places restrictions on the permitted business of OMPs and EMPs. These lessons should be carefully considered in any future regime change.

6

HIGH-LEVEL POLICY OPTIONS

6.1 The market failure analysis (Chapter 4) concluded that there is some scope for intervention. The lessons from the UK regime (Chapter 5) suggest that a more proportionate regime can deliver adequate protection and that certain classes of ‘wholesale’ specialist commodity firms might merit a bespoke simple capital regime.. This chapter therefore looks at the range of policy options available within this review to tackle the market failures identified and fulfil the UK objectives noted in Chapter 3.

6.2 This is a complex review with a variety of different exemptions. There is therefore a wide range of possible outcomes. The diagram below highlights the variety of outcomes for both specialist commodity firms and mainstream commodity firms that could result from changes to the MiFID and CRD exemptions. For example, retaining the MiFID exemptions but bringing more firms into CRD would result in a split outcome (top left box) whereby those firms currently within MiFID would be subject to MiFID and CRD and those firms able to benefit from a MiFID exemption would be outside the EU regulatory framework.



6.3 For simplicity, the paper does not consider each of these different scenarios in turn. Instead, this Chapter looks thematically at the key policy choices noted in Chapter 1, that is:

- which specialist and exotic commodity derivative firms should be covered by the MiFID regulatory regime;
- which commodity and exotic derivative contracts should be classified as financial instruments under MiFID;
- for those firms covered, to design the most appropriate prudential capital supervisory regime and conduct of business framework;

- whether to create a new category of energy investment firm; and
- broader market integrity issues around the commodity and exotic derivatives markets.

There are interconnections between the different policy choices. These are highlighted where relevant.

MIFID SCOPE AND THE COMMODITY EXEMPTIONS: ARTICLES 2(1)(I) AND (K)

6.4 The exemptions in MiFID define the boundary for both MiFID and for CRD. This chapter focuses on the evidence to support inclusion of specialist commodity firms within MiFID. However, the cost-benefit analysis of any proposal to alter MiFID will also closely depend on the outcome of the CRD review (discussed below).

6.5 The evidence from the market failure analysis and UK experience suggests that some form of conduct of business regime is appropriate providing it is tailored to the professional nature of the commodity derivatives markets.

6.6 The exemptions being reviewed are not, however, the only exemptions that commodity firms can benefit from; both Articles 2(1)(i) and (k) of MiFID contain own account dealing commodity exemptions, an own account dealing exemption also exists within Article 2(1)(d). It is therefore necessary to look at the differences and how firms might be affected by any change.

2(1)i 6.7 The Commission and UK view is that the first limb of Article 2(1)(i) exempts own account trading in all MiFID financial instruments. Additionally, unlike the own account dealing exemption in Article 2(1)(d), in HM Treasury and FSA's view Article 2(1)(i) can be combined with other MiFID exemptions. Nevertheless, 2(1)(i) is narrower than 2(1)(d) in that the exemption 2(1)(i) will only apply if what the firm does is ancillary to its main business and that its main business is neither the provision of investment services nor banking services. If a firm is part of a group, the activities must be ancillary to the main business of the group whose main business can be neither the provision of investment services nor banking services.

6.8 HM Treasury and FSA understand that there are some firms who may currently rely on combining the first limb of the Article 2(1)(i) own account dealing exemption (own account trading) with other exemptions e.g. the 'Employee Share Scheme' exemption in Article 2(1)(f) and the 'Group Exemption' in Article 2(1)(b). HM Treasury and FSA consider such firms to be properly outside MiFID scope and so propose pushing for the retention of the first limb of Article 2(1)(i).

6.9 The second limb of the Article 2(1)(i) exemption (providing services in commodity and exotic derivatives to clients of your main business) allows a firm to provide MiFID investment services in commodity and exotic derivatives to third parties and prima facie such business ought to be within MiFID scope. The question then to be considered is whether the restrictions within 2(1)(i) mean that the risks posed by these firms are so reduced that they ought to be carved out of MiFID. On balance HM Treasury and FSA do not think that these restrictions justify the MiFID carve out. This, however, is based on the assumption that the regulatory requirements applied to such firms are proportionate (see below).

2(1)(k) 6.10 Article 2(1) (k) exempts firms whose *main* business is dealing on own account in commodities and/or commodity derivatives as long as they are not part of a group the

main business of which is the provision of other investment services or banking services. Firms exempt under this article are able to provide investment services as long as this does not become their 'main business'.

6.11 HM Treasury and FSA think that the own account dealing exemption should not be available to firms providing *additional* MiFID investment services (e.g. advice and/or arranging deals in commodity derivatives) unless those additional services fall within another MiFID exemption. Furthermore, HM Treasury and FSA do not see the wider scope of 2(1)(k) is justified by the fact that firms captured by the exemption are not part of a wider financial group.

HEDGING

6.12 HM Treasury and FSA are committed to the principle that those firms only entering into commodity derivative transactions in order to hedge underlying commercial exposures should be excluded from MiFID scope. HM Treasury and FSA believe that were UK proposals regarding the MiFID commodity exemptions enacted, firms engaging in such hedging activity would nevertheless be excluded from MiFID through the operation of the dealing on own account exemptions in Article 2(1)(d) and/or (i).

THE 'WITH OR THROUGH' EXCLUSION³⁵

6.13 Currently, the UK operates a UK scope exclusion providing the firm in question trades 'with or through' another UK authorised firm and can rely on another MiFID exemption. HM Treasury and FSA are unaware of any firms that might lose the ability to rely on the 'with or through exclusion' were the exemptions in MiFID articles 2(1)(i) and (k) to be removed. However, HM Treasury and FSA invite stakeholder comment.

ENERGY OPERATORS AND ADMINISTRATORS

6.14 Currently, the UK operates an exemption, from FSMA for certain activities undertaken by operators or administrators of the UK's electricity and gas networks. HM Treasury and FSA are unaware of any firms that might rely on these exemptions and whose activities would not be covered by Article 38(4) of the MiFID regulation were the exemptions in MiFID articles 2(1)(i) and (k) to be removed given the provisions of Article 38(4) remains. However, HM Treasury and FSA invite stakeholder comment.

CHANGES TO MIFID

6.15 Extending the coverage of MiFID reflects HM Treasury and FSA's belief that there is no clear reason why the principle of graded client protections should not apply to commodity derivatives in same way as to all other instruments.

6.16 However, the boundary lines established by MiFID may need tailoring to the different types of clients in the commodity derivatives market. The distinction between non-complex and complex products in MiFID (Art. 38 of implementing directive) may also need reviewing. For example:

- in Annex II, paragraph II (1), clients can request to be treated a professional if they have conducted at least 10 transactions in each of the last 4 quarters.

³⁵ See Article 16 (for dealing as principal) and 22 (for dealing as agent) of the Regulated Activities Order (RAO)

This threshold does not take into account that quite often commodity derivatives market participants engage only in a small number of transactions, but these are large-scale transactions; and

- in Annex II, paragraph I (2), the size threshold is defined on a single entity basis as opposed to a definition on a group basis. This can create problems e.g. for shipping companies engaging in freight derivatives. In shipping business, normally there is a single legal entity for each ship. On a stand-alone basis, these companies do not qualify as a professional market participant. However, on a group basis, the size threshold would easily be met.

6.17 In summary, altering the MiFID exemptions to bring certain limited activities into the scope of MiFID while desirable would only be justified from a cost benefit assessment if the above issues could be addressed and a suitable capital regime agreed (discussed below). In the absence of these changes HM Treasury and FSA would want to reflect on the benefits of bringing these firms into scope.

Q13 – Do you agree that the dealing on own account exemption in Article 2(1)(i) should be retained?

Q14 – Do you agree that the ‘services in commodity and exotic derivatives to clients of your main business’ exemption in Article 2(1)(i) should be removed? If not, why and can you provide evidence to support this?

Q15 – In practice are there any firms that would be brought within MiFID scope were the services in commodity and exotic derivatives to clients of your main business exemption in Article 2(1)(i) to be removed? If so can you identify those firms and the likely cost for them of compliance with MiFID ?

Q16 – Do you agree that the exemptions in Article 2(1) (k) should be removed? If not, why and can you provide evidence to support this?

Q17 – Are there any firms engaging in own account dealing in commodity derivatives that might inappropriately be denied the Article 2(1)(d) exemption e.g. because they might be considered to be a market maker. And if such firms exist would the dealing on own account exemption of Article 2(1)(i) apply to them?

Q18 – In practice, if Article 2(1)(k) was removed would any firms be brought within MiFID scope as a result? If so can you identify those firms and the likely cost for them of compliance with MiFID?

Q19 - Do you agree that were UK proposals regarding the MiFID commodity exemptions enacted, firms engaging in such hedging activity would nevertheless be excluded from MiFID? If not, why not?

Q20 – In practice would any firm lose the ability to rely on the UK's Exemption Order were the exemptions in MiFID articles 2(1)(i) and (k) to be removed? If so who?

Q21 – Do you agree that MiFID client categorisation needs altering? If so, do you have any suggestions as to how it should be altered?

INSTRUMENT DEFINITION

6.18 In reviewing whether the MiFID definition of financial instruments remains appropriate it is important to recall the intent of this definition. Recital 4 of MiFID provides:

‘It is appropriate to include in the list of financial instruments certain commodity derivatives and others which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments’.

6.19 The dividing line that this is establishing is that products or contracts have to resemble traditional financial instruments and have to be associated with the sorts of market failure which financial regulation seeks to address. The market failure analysis indicates that a key issue is information asymmetries and the possibility that these will lead to a socially sub-optimal consumption of certain products.

6.20 In respect of commodity and exotic derivatives, the two elements of the definition of financial instruments which essentially set its outer boundaries are those in sections C(7) and C(10) of Annex I of MiFID. The former relate to physically settled commodity derivative contracts (not traded on a regulated market or MTF) that ‘...shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes..’. The latter relate to exotic derivatives ‘... which have the characteristics of other derivative financial instruments, having regard to whether, amongst other things, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.’

6.21 The criteria in sections C(7) and C(10) of Annex I of MiFID are made operational through a set of factors contained in Article 38 of the Implementing Regulation. There are two common elements to the factors. First, whether or not a contract is a spot contract. Second, the elements contained in article 38(1)(a) to (c) which speak to whether a product or contract has the characteristics of other derivative financial instruments.

6.22 Spot contracts are excluded from the contracts covered by sections C(7) and C(10) of Annex I of MiFID because they are not derivative contracts. But in the spot market there may be delays between a price being agreed and products being delivered. The Commission collected evidence on this issue during the negotiations on what became the Implementing Regulation. HM Treasury and FSA do not believe that the position has changed since the Commission collected its evidence towards the end of 2005. HM Treasury and FSA do not therefore see any justification for changing the definition of a spot contract.

6.23 The elements in article 38 (1)(a) to (c) impose limitations on the types of contract that can fall within C(7) and C(10) of Annex I of MiFID based on features linked to the trading of contracts on regulated markets or MTFs. All have to be satisfied for a contract to fall inside the scope of the definitions of financial instruments in MiFID.

6.24 There are non-spot contracts which might fulfil some rather than all of the conditions laid down in article 38(1)(a) to (c). HM Treasury and FSA do not believe that there is a case for bringing such contracts inside the scope of the definition of financial instruments in MiFID. This is because they have more of the characteristics of purely commercial contracts. In particular relying simply on a contract being margined or

cleared runs a very significant danger of extending financial services regulation to cover transactions which are not in any real sense financial services transactions. The definition of a 'commodity' in Article 1 of the Implementing Regulation is capable of covering most goods. The purchase of many goods involves some form of up-front payment for goods to be delivered at a future date.

6.25 Therefore, HM Treasury and FSA believe that the current definitions of commodity and exotic derivatives contained in MiFID and the Implementing Regulation are 'adequate'. They seem capable of capturing all those contracts that meet the tests set out in Recital 4 of MiFID. Considerable analysis was undertaken on this issue in the MiFID process and no new evidence has come to light that HM Treasury and FSA are aware of to justify change.

Q22 – Do you agree that the definition of a financial instrument remains appropriate? If not, why and can you provide evidence to support this?

Q23 – Do you have any evidence of instruments whose position is unclear in the current terminology?

CRD

6.26 The review requires the Commission to consider whether to retain the capital exemptions for specialist commodity firms and what an appropriate capital regime for such firms might be.

6.27 The market failure analysis suggests that the systemic risks generated by specialist commodity derivative firms appear to be generally lower relative to financial firms. The lessons from the UK regime suggest that a more proportionate regime can deliver adequate protection and that certain classes of 'wholesale' specialist commodity firms might merit a bespoke simple capital regime.

6.28 HM Treasury and FSA see, to date, no case for full application of CRD to such firms and would propose exploring alternative approaches to capital requirements including the possibility of a more principles-based approach. An alternative regime which focuses more on internal risk management and recognises the greater range of risk mitigation, structural risks and financial assets that are relevant to such firms may be more appropriate for such firms. Indeed 16 EEA States, including the UK, already have alternative prudential national legislation in place governing firms active in the commodity derivatives sector.³⁶ The Oil Market Participant (OMP) regime in the UK, for example, requires firms to hold 'adequate resources' but balances this by imposing strict conditions on the types of business such firms can undertake. There are some proposals from industry for an alternative method of calculating capital requirements for such firms. HM Treasury and FSA propose considering these and other alternative methods for delivering appropriate systemic risk protections against the failure of specialist commodity derivative firms. A key step would be agreeing what the appropriate benchmark for such a regime should be.

6.29 It is also clear that the CRD Pillar 1 requirements present some problems when applied to financial firms. Particular difficulties arise in relation to market risk, settlement risk, counterparty credit risk and concentration risk requirements. Problems

³⁶ Denmark, Germany, Spain, France, Ireland, Italy, Netherlands, Austria, Finland, Sweden, UK, Estonia, Hungary, Slovenia, Liechtenstein and Norway. www.c-eps.org/press/documents/CO_%20Supervisory%20survey.pdf.

also arise in relation to the calculation of eligible capital and the requirement to deduct fixed assets from equity for those entities that own physical infrastructure such as refineries, pipelines and power stations.

6.30 For example, the Maturity Ladder Approach (MLA) in CAD Annex IV requires all commodity positions, whether spot or forward, to generate a market risk charge based on the 'spot price', which is an undefined term. For forward/future positions in commodities where there is a low correlation between spot and forward price, it is risk insensitive and so undesirable to calculate a market risk charge based on the prevailing spot price. A low correlation between spot and forward exists for commodity derivative positions where the underlying physical commodity is non-storable or where the amount of storage is so limited that it doesn't materially influence the spot price. Presently power (electricity) and gas are examples of such commodities. For such commodities the MLA should calculate a market risk charge by using the forward price curve as this is more risk sensitive.

6.31 An appropriate capital regime is the key outcome of this review. Excessive capital costs may drive some commodity derivative firms out of the market leading to a sub-optimal allocation of resources and reduced market liquidity. More onerous capital requirements could also impact the international competitiveness of EU commodity derivative markets. HM Treasury and FSA do not see a case for full application of CRD to specialist firms and indeed see a need for remedial changes to CRD in its application to financial firms.

Q24 - Do you agree that a differentiated capital regime would offer sufficient protection to specialist firms? Do you have any suggestions as to what such a regime might look like? Do you have any quantitative evidence on the likely cost of compliance with full CRD?

Q25 – Do you have any evidence of level playing field problems?

Q26 - Do you have any further changes that you would want to see to capital requirements for mainstream firms in relation to commodity derivatives business? If so, what?

Q27 – What are your views on the Pillar 2 type approach put forward by a section of industry?

BESPOKE ENERGY REGIME

6.32 As part of the review, the Commission is to consider whether a pure energy regime is justified. The experience from the UK is that such a regime has offered a proportionate outcome.

6.33 HM Treasury and FSA propose considering a bespoke concessionary regime for firms only engaging in energy commodity investment activities and services. HM Treasury and FSA would also be interesting in views as to whether this approach is suitable for a wider range of firms. HM Treasury and FSA believe the tighter restrictions applied to such firms in the UK (most notably the prohibition on dealing with retail clients) are an important tool for ensuring the risks posed by a lighter regime are kept strictly within the wholesale markets.

Q28 – Do you agree that a bespoke concessionary regime is a proportionate approach to the regulation of firms who only engage in energy commodity investment activities and services? Why and do you have any suggestions as to what it would look like?

Q29 - Do you think this approach is suitable for a wider range of firms? If not, why and can you provide evidence to support this?

MARKET TRANSPARENCY

6.34 Wider issues raised in connection with the review include the need for rules on pre or post-trade transparency for commodity derivatives. The market failure analysis and the lessons from the UK regime suggest that the case for such rules has not been made.

6.35 HM Treasury and FSA have found little evidence to date of material failures regarding transparency across those markets. Transactions in standardised products (e.g. futures) often take place on exchange or via the facilities of an MTF operator where regulatory or exchange-set transparency arrangements apply. Most trading of commodity and exotic derivatives takes place on an OTC basis. The markets themselves, however, drive transparency for OTC activity which does not appear to be leading to market failure. For those active in the OTC space, information on prices in the underlying markets and other on-exchange data, models and market-driven transparency information (e.g. broker screens) are often used for pricing. Existing retail participation is very limited concentrated in products, e.g. Exchange Traded Funds (ETFs), for which there appears to be sufficient transparency. In addition, transparency information may be of little or no value in some circumstances (e.g. for highly bespoke derivatives).

6.36 Issues have been raised as to whether the underlying physical gas and electricity markets are sufficiently transparent and the recent DG TREN proposals have been put forward in that connection. However, to the extent changes are put into effect to increase transparency in those underlying markets, it would not necessarily follow that increased transparency requirements should be extended to the related derivatives markets. Increased transparency may, possibly, reduce market liquidity and the willingness of market participants to make markets.

6.37 HM Treasury and FSA do not believe that any case has yet been made for regulatory action to be taken at this stage with respect to transparency in those markets. HM Treasury and FSA believe that generally mandating transparency in those markets would be neither proportionate, nor cost effective and would not fit with the growing focus on better regulation.

Q30 – Do you have any evidence of problems in relation to transparency in the derivatives market?

TRANSACTION-REPORTING

6.38 A further issue that may be raised in the review is the role of transaction reporting for commodity derivatives. The lesson of the UK regime is that such reporting offers little value and that position reporting is the more commonly used tool.

6.39 The nature of abuse most commonly found on commodity derivative markets is typically through attempts to corner or squeeze the market. Position reports are acknowledged as the standard tool for monitoring of these markets, whereas transaction reports alone do not provide the information required to enable the detection of this type of abuse.

6.40 HM Treasury and FSA believe that the costs to firms and exchanges of collating and submitting this data and the management of this data by competent authorities significantly outweighs any benefits that transaction reports may provide. HM Treasury and FSA would therefore propose that MiFID be amended to remove commodity derivatives from the scope of the transaction-reporting regime.

Q31 – Do you agree that commodity derivatives should be removed from the scope of the MiFID transaction-reporting regime? Why?

Q32 – Do you see benefit in position reporting? Why?

MARKET ABUSE

6.41 Promoting clean, orderly and efficient markets is a central UK objective. Sections of industry are calling for the extension of Market Abuse Directive to cover additional commodity markets e.g. commodity MTFs. Given that the Commission is to conduct a review of the Market Abuse Directive in 2008 HM Treasury and FSA believe that is the appropriate forum in which to consider such options.

Q33 – Do you agree that market abuse issues are better looked at in the EU's market abuse review? HM Treasury and FSA would nevertheless be interested in any strong views on desirable changes to help prepare for said review?

SUMMARY

6.42 UK provisional analysis has led to the following preliminary policy recommendations.

- Some slight alterations to the MiFID scope would merit consideration, providing an appropriate capital regime can be agreed.
- No changes appear to be required to the MiFID definition of financial instruments.
- A proportionate capital regime for all specialist commodity derivative firms has the greatest merit.
- A bespoke capital and conduct of business regime for oil and energy players (and possibly wider) that do not deal with retail clients may also be of value.
- Some minor modifications to the CRD regimes for financial firms engaged in commodity business.
- No changes appear to be required to transparency rules for the commodity derivative markets.

- Commodity derivatives should be carved out of the MiFID transaction reporting regime and the benefits of position reporting considered.
- There are issues to be considered in relation to market abuse but these could better be picked up in the forthcoming Market Abuse Directive review.

Considering this against UK objectives

6.43 By way of a high level summary, the following table brings together the UK objectives established in Chapter 3 with the policy suggestion identified above.

To promote market confidence, stability and efficiency by keeping to an acceptable level the negative externalities associated with failures of specialist commodity derivative firms.	The limited negative externalities suggest a bespoke capital regime should offer proportionate protection.
To provide proportionate levels of investor protection by ensuring market participants have adequate information and appropriate protections, including against market abuse.	Inclusion within MiFID of a slightly wider range of firms will ensure that all clients receive appropriate protections.
To maintain the global competitiveness of firms by ensuring the global attractiveness of the EU commodity derivatives sector.	A proportionate regime should not impose an excessive burden on the EU commodity derivatives business.
To facilitate competition between firms by avoiding unjustified differences in treatment between commodity derivatives market players.	Some difference in regulatory treatment appears justified; there is no evidence to date that a differentiated UK regime has created problems.
To promote a liquid single market in commodity and exotic derivatives by facilitating the growth of, and innovation in, emerging markets in commodity markets	A proportionate regime should not drive current participants out of the market and should encourage new entrants.
To promote a regime regulating commodity and exotic derivative firms that is: proportionate to the risks; outcomes-focused; senior management-focused; and is, where appropriate, principles-based.	Differentiated, principles-based regulatory approach justifies retaining differences in treatment between firms.

HOW TO RESPOND

7.1 Responses are requested by 14 March 2008. Questions are posed throughout the paper. Wherever possible HM Treasury and FSA welcome clear factual and/or quantitative responses. A summary of responses will be issued in Spring 2008. Officials will continue to liaise with industry throughout the Review. HM Treasury and FSA will consult should changes to UK legislation and the FSA's Handbook be required following the Commission's work.

7.2 As noted, HM Treasury and FSA invites comments on this discussion paper by 14 March 2008. A specific list of questions is included in a subsequent section, but respondees are, of course, free to frame their responses as they see fit.

7.3 HM Treasury's and FSA's preference is to receive responses in electronic format only (all e-mail responses will be acknowledged). When responding, please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

Please could comments be sent to:

Jenny Warson
Financial Stability and Risk Team
Room 3/19
1 Horseguards Road
London
SW1A 2HQ

Email: jenny.warson@hm-treasury.x.gsi.gov.uk

Queries about this discussion paper should be addressed as appropriate to:

For CRD issues:

jenny.warson@hm-treasury.x.gsi.gov.uk

Telephone: 020 7270 5219

For MiFID issues:

Sarah.Parkinson@hm-treasury.x.gsi.gov.uk

Telephone: 020 7270 5912

For FSA issues:

stephen.sie@fsa.gov.uk

Telephone: 020 7066 3418

7.4 A list of those consulted is attached in Annex E. If you have suggestions of others who may wish to be involved in this process, please contact HM Treasury and FSA.

Confidentiality disclosures

7.5 Information provided in response to this discussion, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental information Regulations 2004).

7.6 If you want the information that you provide to be treated as being confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain why you regard the information you have provided as confidential. If a request to disclose the information is received HM Treasury and FSA will take account of your explanation, but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury or FSA.

7.7 HM Treasury will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

CODE OF PRACTICE

7.8 The discussion process is being conducted in line with the Code of Practice on Consultation. The criteria are listed below, a full version of the criteria can be found at:

www.cabinetoffice.gov.uk/regulation/Consultation/Code.htm

The six consultation criteria

1. Consult widely throughout the process, allowing a minimum of 12 weeks for the written consultation at least once during the development of the policy.
2. Be clear about who may be affected, what questions are being asked, and the timescale for responses.
3. Ensure that your consultation is clear, concise and widely accessible.
4. Give feedback regarding the responses received and how the consultation process influenced the policy.
5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
6. Ensure your consultation follows better regulation, including carrying out a Regulatory Impact Assessment if appropriate.

Complaints

If you have any complaints about any element of the discussion process leading from the issue of this document, please contact:

Better Regulation Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

RELEVANT LEGAL PROVISIONS

DIRECTIVE 2004/39/EC ON MARKETS IN FINANCIAL INSTRUMENTS

Article 2 exemptions

This Directive shall not apply to:

(i) persons dealing on own account in financial instruments, or 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, when considered on a group basis, 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;

(k) persons whose main business consists of dealing on own account in commodities and/or commodity derivatives. This exception shall not apply where the persons that deal on own account in commodities and/or commodity derivatives are part of a group the main business of which is the provision of other investment services within the meaning of this Directive or banking services under Directive 2000/12/EC;

Article 65 reports and review

(3) Before 30 April 2008, the Commission shall, on the basis of public consultations and in the light of discussions with competent authorities, report to the European Parliament and to the Council on:

(a) the continued appropriateness of the exemption under Article 2(1)(k) for undertakings whose main business is dealing on own account in commodity derivatives;

(b) the content and form of proportionate requirements for the authorisation and supervision of such undertakings as investment firms within the meaning of this Directive;

(d) the continued appropriateness of the exemption provided for in Article 2(1)(i).

REGULATION 1287/2006/EC IMPLEMENTING DIRECTIVE 2004/39/EC ON MARKETS IN FINANCIAL INSTRUMENTS

Article 40 re-examinations

(2) The Commission shall, after consulting the Committee of European Securities Regulators, re-examine the provisions of Articles 38 and 39 relating to criteria for determining which instruments are to be treated as having the characteristics of other derivative financial instruments, or as being for commercial purposes, or which fall within Section C(10) of Annex I to Directive 2004/39/EC if the other criteria set out in that Section are satisfied in relation to them.

The Commission shall report to the European Parliament and to the Council at the same time that it makes its reports under Article 65(3)(a) and (d) of Directive 2004/39/EC.

DIRECTIVE 2006/49/EC ON THE CAPITAL ADEQUACY OF INVESTMENT FIRMS AND CREDIT INSTITUTIONS (RECAST)

Article 48

(1) The provisions on capital requirements as laid down in this Directive and Directive 2006/48/EC shall not apply to investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the financial instruments set out in points 5, 6, 7, 9 and 10 of Section C of Annex I to Directive 2004/39/EC and to whom Directive 93/22/EEC (1) did not apply on 31 December 2006.

This exemption is available until 31 December 2010 or the date of entry into force of any modifications pursuant to paragraphs 2 and 3, whichever is the earlier.

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

(a) an appropriate regime for the prudential supervision of investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the commodity derivatives or derivatives contracts set out in points 5, 6, 7, 9 and 10 of Section C of Annex I to Directive 2004/39/EC; and

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

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

B

EXISTING EUROPEAN AND DOMESTIC REGULATORY REGIMES

EU

B.1 The Markets in Financial Instruments Directive (MiFID), introduced to replace the outdated ISD, was implemented on 1 November. MiFID extends the definition of Financial Instruments from that in the ISD to include Commodity Derivative contracts and other derivatives on underlyings such as climatic variables and emission allowances (see Annex 1, Section C, paragraphs 5, 6, 7, and 10). There will therefore be some commodity firms that were previously exempt under ISD that will now be covered by MiFID and therefore CRD. However, not all commodity firms will be affected since MiFID and CRD include a variety of exemptions.

B.2 Banks and Investment Firms that deal on own account or provide investment services in commodity derivatives are subject to the CRD capital regime in relation to that commodity activity. Unless they fall within the transitional capital exemption for specialist commodity derivative firms.

B.3 Under MiFID reports of transactions in commodities fall to be made to and, as appropriate exchanged between, regulators in the same manner as transactions in other financial instruments. CESR has agreed a pragmatic solution whereby the home competent authority of a commodities/forex/interest rate derivative market receives transaction reports directly from that market on behalf of all the other competent authorities. Instead of automatically exchanging those reports, the authority of the market would store the data and respond on an ad hoc basis to requests for transaction reports from other CESR member. Firms will not have to report transactions in these products to their regulators.

B.4 MiFID introduced mandatory pre- and post-trade transparency for transactions in shares admitted to trading in regulated markets, whether or not those transactions are carried out on a regulated market or an MTF. No additional EU transparency requirements are currently in place. A separate Commission work stream is examining the desirability of extending transparency for transactions in financial instruments other than shares, in addition to its investigation of transparency issues in the context of the Commodity Review.

B.5 The Market Abuse Directive (MAD) created an EU-wide market abuse regime. MAD defines what behaviour will be considered as market abuse, namely insider dealing and market manipulation. There is a separate description of inside information for the commodity derivative markets. The MAD applies to any financial instrument admitted to trading on a regulated market, or those where a request for admission to trading has been made. The Directive includes a series of preventative measures aimed at reducing the incidence of market abuse e.g. it obliges firms to report suspicious transactions to the competent authority.

UK

Scope B.6 In the commodities space, the FSA perimeter is wider than MiFID's as regards firms and is slightly wider in some respects as regards regulated financial instruments. The UK currently takes an activities-based approach to the regulation of commodity business, and whilst there are certain exclusions in the Regulated Activities Order (RAO) which certain commodity firms take advantage of to remove them from the

requirement for authorisation (and so regulation) - there are no equivalent exemptions to MiFID's 2(1)(i) and (k) to carve out specialist commodity firms.

B.7 There are two areas where the UK's regulation of commodity derivative instruments is slightly wider than that required by MiFID. These are as follows:

- First, physically settled options. All physically settled options on palladium, platinum, gold or silver are inside the scope of UK regulation whether or not they meet the requirements of paragraphs 5, 6, 7 or 10 of Section C of Annex 1 to MiFID.
- Second, physically settled futures. Physically settled futures are regulated in the UK where a contract is deemed to be for 'investment purposes'. It is conceivable, although generally unlikely, that a physically-settled contract which does not meet the requirements of paragraphs 5,6, 7 or 10 of Section C of Annex 1 to MiFID would be regarded as being for investment purposes.

B.8 The current scope of regulation of options on precious metals reflects the prominence of the London-based bullion market. The 'investment purposes' test for futures is trying to capture similar futures to those in MiFID (i.e. instruments 'which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments') but is just specified slightly differently.

B.9 In implementing MiFID, the UK decided not to narrow its existing regulatory boundaries to align them with those in the directive in this area. This was because of the uncertainties related to the Article 65 review. The intention is to revisit the issue in the light of the review's conclusions.

Prudential requirements

B.10 For regulated non-MiFID as well as MiFID specialist commodity derivative firms the UK imposes a capital regime that has similarities to the CAD/BCD regime through IPRU (INV) Chapter 3 of the FSA Handbook.³⁷ However, the following commodity market participants are/can be exempted from applying prudential requirements (though they will remain subject to the FSMA threshold requirement which requires that they maintain adequate, including financial, resources).

B.11 Oil Market Participants (OMPs) do not need to apply capital rules as long as they are not members of a recognised or designated investments exchange that are entitled to trade with other members. In summary, an OMP is a firm which:

(a) only engages in regulated activity in relation to an oil investment or to oil which:

(i) is the executing of own account transactions on any recognised investment exchange or designated investment exchange ; or

(ii) if it is not the executing of transactions on such exchanges, is performed in connection with or for persons who are not individuals;

(b) is only establishing, operating or winding up a collective investment scheme which is an oil collective investment scheme in which individuals do not participate.

B.12 Energy Market Participants (EMPs) whose main business consists of the generation, production, storage, distribution and/or transmission of energy can apply

³⁷ <http://fsahandbook.info/FSA/extra/4517.pdf>

to the FSA to waive prudential requirements. Energy is defined as coal, electricity, natural gas (or any by-product or form of any of them) or oil. In summary, an EMP is a firm which:

(a) only engages in regulated activity in relation to an energy investment or to energy which:

(i) is the executing of own account transactions on any recognised investment exchange or designated investment exchange; or

(ii) if it is not the executing of transactions on such exchanges, is performed in connection with or for persons who are not retail customers;

(b) is only establishing, operating or winding up a collective investment scheme which is an energy collective investment scheme in which retail clients do not participate.³⁸

Conduct of business and organisational requirements

B.13 Regulated UK non-MiFID scope authorised commodity firms will face one of two conduct of business regimes. Firms who deal in oil and energy market derivatives and who do not interact with retail clients have a specialist regime which disappplies most of the sort of conduct of business rules found in articles 19, 21 and 22 of MiFID.³⁹ The disapplication of rules reflects the perceived lower risks to consumer protection of this business. Other non-MiFID scope authorised commodity firms face a conduct of business regime that is broadly similar to that in MiFID.

B.14 Regulated UK non-MiFID commodity firms are subject to organisational requirements that cover broadly similar ground to that in MiFID Level 1 Article 13, although the exact standards sometimes differ from those in MiFID. These are contained in SYSC Chapter 3 of the FSA's Handbook.⁴⁰

B.15 MiFID commodity derivative firms must apply the MiFID COB and organisational requirements regime as implemented in the FSA Handbook.

Market integrity regime

B.16 The UK Market Abuse Regime applies to all qualifying investments admitted to trading on prescribed markets as well as those investments that are related investments in relation to such qualifying investments. The Commodity Markets that are prescribed markets are all the UK's commodity derivatives exchanges (ICE Futures Europe, LME, LIFFE and ETFs/Commodity based securities on the LSE) and these are subject to UK Market Abuse Regime whilst Commodity MTFs (the main ones being Spectron, ICAP, GFI, Prebon) are not.

7.9 The UK's implementation of MAD is super-equivalent at least until 30 June 2008 and will be the subject of a separate HM Treasury domestic review.

³⁸ For the full and complete definition of an OMP or EMP see FSA Handbook at <http://fsahandbook.info/FSA/html/handbook/>.

³⁹ See Conduct of Business Sourcebook Ch 1.6 <http://fsahandbook.info/FSA/html/handbook/COB/1/6>.

⁴⁰ <http://fsahandbook.info/FSA/html/handbook/SYSC/3>.

OVERVIEW OF THE COMMODITY DERIVATIVES MARKET

INTRODUCTION

C.1 To design effective regulation of this sector, it is essential to have a clear understanding of the nature of commodity derivative markets. This overview of the commodity derivatives market is structured as follows:

Market overview

- what commodity derivatives are and the range of products available;
- the benefits and risks associated with commodity derivatives;
- the types of trading available; and
- the types of participants.

Growth of the market

- the growth of the derivatives market, and commodity derivatives market in particular; and
- the future direction of the market.

MARKET OVERVIEW

The underlying physical commodities market

C.2 Commodity markets tend to be categorized by product. Some examples of the main types of commodities products are noted below.

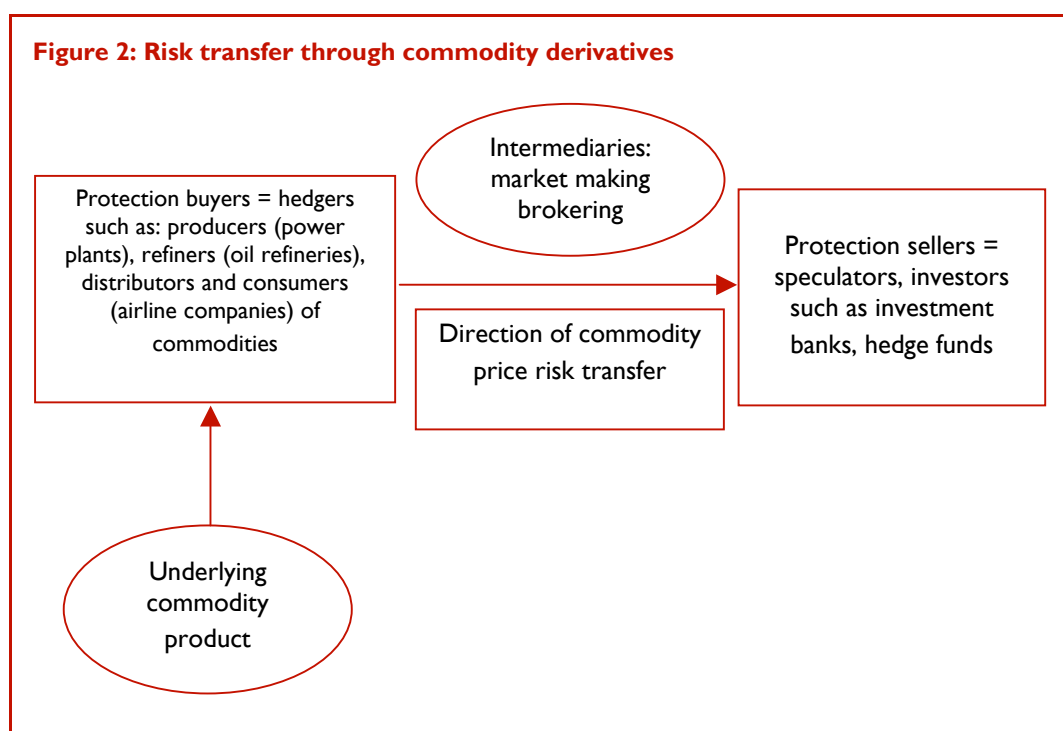
- **Metals:** precious - gold, silver, platinum; base - copper, nickel, aluminium; and minor – chromium.
- **Energy:** petroleum products; natural gas; and electricity.
- **Softs:** foods and fibres - coffee, cocoa, sugar; grains and oilseeds – wheat, rice; livestock and meat; and others - potatoes, rubber.
- **Developing:** weather; emissions; and plastics.

C.3 Price volatility has been a feature of the markets in primary commodities - such as coffee, copper, cotton, wool, rubber, tin – with imbalances between supply and demand giving rise to wide fluctuations in prices. For example, primary commodities often have long production cycles which are difficult to adjust to bring into equilibrium with relatively short-run fluctuations in demand. Since 2001, there has been a sharp upward trend in prices of many commodities due to increasing demand, mainly in China and India, rising interest from investors and limited supply of some commodities such as oil. Prices are also affected by external shocks like political uncertainty; the weather; lack of industry investment in infrastructure. ⁴¹

⁴¹ International Financial Services Limited.

THE COMMODITY DERIVATIVES MARKET

C.4 Commodity derivatives are financial instruments that transfer commodity price risk from one party to another. They derive their value from that of an underlying variable, that is, the price of the commodity. A wide range of commodity derivative products exists in both traditional commodities such as oil and gas, as well as new commodities such as plastics, coal, emissions, energy and weather.⁴²



C.5 Commodity derivatives therefore provide a set of risk management tools. These enable market participants to manage their physical and financial risks more efficiently. Ultimately, commodity derivatives reduce the risk that commodity price volatility could pose to the wider economy.

C.6 More specifically, commodity derivatives (like any other type of financial instrument) enable the following activities to occur: hedging, speculation, arbitrage, market making, brokering, and investment.

C.7 Although the benefits are evident, the estimation of commodity derivatives' contribution to the UK economy in terms of shares of GDP, employment and overseas earnings is not straightforward, given the breadth of the sector and the diversity of participants.⁴³

C.8 Commodity and exotic derivatives business poses risks to market participants that are the same in nature (though not necessarily size) as the risks generated from other financial business e.g. systemic, operational, credit, market and liquidity risks as well as investor protection concerns. However, the risks to the broader economy in the event of the failure of a participant include not only disturbance to the financial

⁴² Financial Services Authority (2007): Growth in commodity investment: risks and challenges for commodity market participants.

⁴³ International Financial Services Limited (2007): Derivatives 2007.

markets but also potential dislocation of physical supply and demand. These risks are discussed further in the market failure analysis.

TRADING VENUES

C.9 There are three types of commodity derivative trading venues: OTC; on-exchange trading; and MTFs.

OTC Derivatives Trading

C.10 Traditionally, derivatives in general have been associated with over-the-counter trading rather than on-exchange trading, reflecting industry's need for tailored contracts.⁴⁴ As at December 2006, the notional value of outstanding OTC commodity derivatives stood at \$6,938m, close to a five-fold increase on the position as at December 2004 (See Figure 2).⁴⁵ BIS anecdotally suggests that up to 90 per cent of swaps and options in oil trading are done over-the-counter.⁴⁶

Figure 2: Notional amounts outstanding of commodity derivatives contracts

Date	December 2004	June 2005	December 2005	June 2006	December 2006
Amount (US\$ billions)	1,443	2,940	5,434	6,394	6,938

SOURCE: BIS Quarterly Review, March 2007

Exchange Traded Commodities

C.11 On exchange trading in physical commodities and commodity derivatives more than doubled in volume between 2001 and 2005, reaching 878 million contracts.⁴⁷ As with the OTC commodity derivative market, it should be noted that commodity exchange activity is small relative to on-exchange trading in more traditional financial products e.g. interest rate and equity derivatives accounting for more than 90 per cent of all on-exchange derivatives trades, and there is no reason to expect a fundamental change in the foreseeable future.⁴⁸

C.12 London is the largest centre for commodities trading after New York, hosting three major derivatives exchanges that account for 15 per cent of the global trade in commodities: London Metal Exchange, the main global exchange for non-ferrous metals; ICE Futures Europe, Europe's biggest exchange for energy products; and LIFFE, Europe's biggest exchange for soft commodities.⁴⁹

- **London Metal Exchange (LME):** the LME offers futures and traded option contracts in the main non-ferrous industrial metals, accounting for 95 per

⁴⁴ Bank for International Settlements (2007): Semi-annual OTC derivatives statistics at end-December 2006 & Statistics on exchange traded derivatives.

⁴⁵ Bank for International Settlements (2007): Semi-annual OTC derivatives statistics at end-December 2006.

⁴⁶ Bank for International Settlements (2007): Financial investors and commodity markets.

⁴⁷ International Financial Services Limited (2006): Commodities Trading.

⁴⁸ Futures Industry Association (2007): Derivatives Exchange Volume Accelerates in 2006.

⁴⁹ International Financial Services Limited (2007): Derivatives 2007.

cent of total global trading.⁵⁰ More specifically, the LME offers futures and traded options contracts on six primary metals – aluminium, copper, nickel, tin, lead and zinc and two aluminium alloy contracts, as well as a composite index of these metals. In 2005, the LME launched the world’s first futures contracts for plastics, followed by the introduction of regional plastics contracts in 2007. The LME also offers LMEminis, smaller-sized contracts for copper, aluminium and zinc, plus an index contract.

- Trading takes place across three trading platforms: through open-outcry trading in the ‘Ring’, through an inter-office telephone market and through LME Select, the Exchange’s electronic trading platform.⁵¹ Turnover of LME contracts rose by 11 per cent in 2006 to reach 87m contracts, equivalent to over \$8,000bn. Primary aluminium has been the most widely traded metal in recent years: it account for 47 per cent of trading in 2006, followed by copper accounting for 24 per cent and zinc 15 per cent. Despite its London location the LME is a global market with an international membership and with more than 95 per cent of its business coming from overseas.
- **Ice Futures Europe:** a subsidiary of Intercontinental Exchange, ICE Futures Europe operates the leading electronic regulated futures and options exchange for global energy markets and offers liquid markets in the world’s leading oil benchmarks: Brent Crude and West Texas futures, trading nearly half of the world global crude future by volume of commodity traded. Other major energy contracts include: Gas Oil futures and options, Natural Gas futures, Baseload and Peakload energy electricity contracts, coal futures and ECX carbon financial instruments.
- Average daily commissions in OTC energy products on ICE rose 88 per cent in the first five months of 2006, following 80 per cent growth in 2005 and 75 per cent in 2004⁵². ICE Futures Europe reported total volume in August 2007 of 11,990,805 contracts, up 28.4 per cent compared to 9,338,903 contracts in August 2006. The ICE Brent Crude futures accounted for the bulk of trading with 78 per cent of contracts in August 2007, followed by ICE Gas Oil futures with 19 per cent.⁵³
- **LIFFE:** the international derivatives business of Euronext, now a subsidiary of NYSE Euronext. The exchange’s electronic trading platform LIFFE CONNECT provides a single European market for all its derivatives products listed on its Amsterdam, Brussels, LIFFE, Lisbon and Paris exchanges. Derivatives markets supported by LIFFE CONNECT are also available to customers at over 820 locations in 31 countries worldwide.⁵⁴
- Every day, business worth over €1,100 billion is transacted on LIFFE by customers based worldwide. LIFFE lists a diverse range of commodity futures and options which includes Cocoa, Robusta Coffee, Raw Sugar,

⁵⁰ International Financial Services Limited (2006): Commodities Trading.

⁵¹ See http://www.lme.co.uk/questions_faqs.asp.

⁵² International Financial Services Limited (2006): Commodities Trading.

⁵³ See http://files.shareholder.com/downloads/ICE/183855799x0x130077/28bb193c-3835-4f9f-a515-809c98e78c6d/ICE_News_2007_9_5_General_Releases.pdf.

⁵⁴ International Financial Services Limited (2007): Derivatives 2007.

White Sugar, Feed Wheat, Milling Wheat, Rapeseed, Corn and Rapeseed Oil.⁵⁵

Multilateral Trading Facilities

C.13 Multilateral Trading Facilities have gained in importance in several financial markets around the world as an alternative to traditional exchanges, or as a complement to voice broking and bilateral OTC trading. The UK has been no different and today hosts over 20 UK-based MTFs active in markets for equities, bonds, financial derivatives and commodities. It also hosts a number of firms that are affiliated with overseas-based MTFs.⁵⁶ In comparison with traditional exchanges, MTFs can reduce transaction costs, as well as offering access to after hours trading and innovative investment categories.⁵⁷

C.14 Some of the UK's key MTFs are described below.

- **GFI:** GFI acts as an intermediary between large, institutional buyers and sellers, with a primary focus on complex, and often less liquid, markets for sophisticated financial instruments, primarily OTC derivatives.⁵⁸
- **ICAP:** ICAP is the world's largest interdealer broker with an average daily transaction volume in excess of USD 1 trillion, more than 50 per cent of which is electronic. The Group is active in the wholesale markets for OTC derivatives, fixed income securities, money market products, foreign exchange, energy, credit and equity derivatives.⁵⁹
- **Prebon:** Prebon Energy is a division of the Prebon Group and offers one of the largest OTC energy broking networks in the world, encompassing a wide range of energy-related products. Prebon Energy's Emissions Group is a major broker of all emissions related products including: allowances, emissions reduction credits (ERCs), green house gases, and renewable energy credits.⁶⁰
- **Spectron:** Spectron acts as an intermediary broker in a number of wholesale energy markets, including natural gas, electricity, oil, coal, metals, weather, petroleum products and emissions – with more than \$150 billion worth of energy products trading through Spectron annually.⁶¹

MARKET PARTICIPANTS

Professional And Institutional Investors

C.15 Traditionally, hedgers have constituted the most active force in the market, using commodity derivatives to protect their business – whether as producer or purchaser – from changes in the price of the underlying commodity, i.e. they transfer

⁵⁵ See www.euronext.com.

⁵⁶ Financial Services Authority (2002), CPI 53: Alternative trading systems.

⁵⁷ Deutsche Bank Research (2006): Alternative trading systems: a catalyst of change in securities trading.

⁵⁸ See http://www.gfigroup.com/portal/pdfs/gfi_%20annual_report_2006.pdf.

⁵⁹ See <http://www.icap.com/investor-relations/about.aspx>.

⁶⁰ See <http://www.prebonenergy.com/index.aspx>.

⁶¹ See http://www.spectrongroup.com/Portals/_default/Skins/SpectronSkin/about.aspx.

price risk to another party. In recent years, however, there has been a marked change, as more private and institutional investors have sought to hedge inflation through greater exposure to commodities as opposed to equities. The rising price of oil, industrial goods and precious metals has also drawn speculators and investors to the market.⁶² Investors and speculators therefore take on price risk for portfolio diversification or pure speculation.

C.16 As liquidity has expanded, new entrants such as hedge funds have also entered commodity markets, improving price discovery and adding more liquidity. Hedge funds are increasingly hedging their own commodity price risk as they become owners of physical assets such as power plants, while also seeking to benefit from direct investment in commodities and commodity derivatives.

C.17 Alongside this is the emerging trend of greater investment in commodities by institutional investors such as pensions and insurance companies, typically gaining exposure via commodity indices. For UK companies, the trend is very much in its infancy, but pension funds in other countries (in particular Holland and Germany) are typically keener to invest in commodities. The Dutch have led the way, owing to both a flexible regulatory environment and a willingness to build in-house commodity expertise (as opposed to relying upon outside consultants, as is the norm in the UK). ABP (Dutch civil service pension fund) has \$226 billion Assets Under Management (AUM) and 2.7 per cent currently invested commodities.⁶³ In October 2007, the Fonds de Réserve pour les Retraites, France's state pension reserve fund, also announced its plans to build on its existing commodities investment programme by investing up to €2bn (\$2.7bn) in a passive commodities index tracker.⁶⁴

Retail Investment

C.18 The 2007 FSA paper on commodity derivatives noted the lack of direct retail investment in commodity derivatives. This is not surprising when the accessibility of that market is contrasted with equity market accessibility. For example, the smallest tradable contract size of copper was until recently about \$170,000 on on-exchange commodity trading, whilst for Brent crude it reached about \$70,000 at the height of 2006's price increases (1 lot = 1000 barrels). On 4 December LME introduced 'mini' contracts in copper, zinc and aluminium, for which one lot of copper is worth about \$35,000. It is therefore likely that only high net worth individuals would have sufficient assets to manage a diversified portfolio of commodity derivative instruments for themselves.

C.19 There are, however, many ways in which retail and private investors can gain indirect exposure to commodity derivatives. Some of these are described below.

- **Professionally managed commodity derivative funds** - one of the easiest ways to add commodities to a portfolio while simultaneously diversifying the risk among these commodities is to buy into a commodity index fund.⁶⁵ Commodity index funds enable investors to 'buy the market' in a single investment; those running the funds take on the expense of trading and researching the individual commodities in the index. Buying the market also

⁶² International Financial Services Limited (2006): Commodities Trading.

⁶³ Financial Services Authority (2007): Growth in commodity investment: risks and challenges for commodity market participants.

⁶⁴ See http://www.fondsdereserve.fr/IMG/pdf/CommoditiesRFP_Oct162007.pdf.

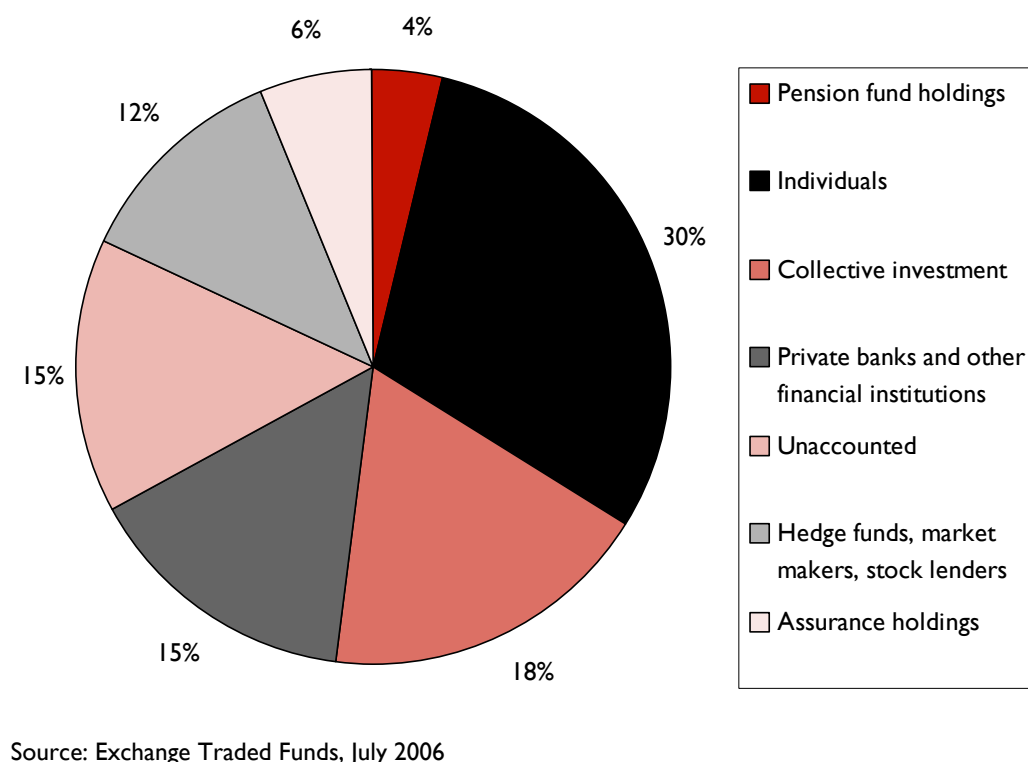
⁶⁵ Financial Services Authority (2007): Growth in commodity investment: risks and challenges for commodity market participants.

ensures a balanced and diversified basket of commodities – losses from one sector should be counterbalanced by gains from another. Investment in index funds has grown dramatically in the last five years, and they are the largest market players in terms of AUM. The Goldman Sachs Commodity Index (GSCI) was launched in the 1980s and by the early 1990s had grown to \$1bn AUM . In 2001 its value was in the range of \$4-5 billion, and has grown to \$55-60 billion currently. Of all the commodity index funds the GSCI is by far the largest. Other significant funds include the Dow Jones AIG Commodity Index which has an estimated \$10-15bn AUM, the Deutsche Bank Liquid Commodity Index and the Rogers International Commodity Index which have less (c. \$5bn). The number of index funds has been increasing steadily over the past few years. Most of these start with the GSCI weightings, and then go over/under weight in certain areas.⁶⁶

- **Exchange Traded Funds (ETFs)** - offer an alternative route for retail investor to enter the commodities market. In a recent survey by Edhec Business School, 55 per cent of respondents expected increased use of ETFs and 36 per cent expected commodities to be the one of the biggest growth areas. Of the 122 institutional investors and asset managers surveyed 15 per cent currently trade ETFs and a further 20 per cent expressed interest in doing so soon. At present investment in ETFs is relatively limited and retail and intermediate customers make up only 30 per cent of this small amount. However these products are possibly the first with the potential to open commodities to retail investors. Figure 5 shows the breakdown of UK and European ETF investors. The total size of holdings of gold by ETFs as of 7 July 2006 was 516 tonnes, which was equivalent to \$11.4bn at the then prevailing prices. Assuming individuals are equally well represented in gold ETFs as for ETFs more generally, this would suggest a figure of \$3.4bn retail investment globally (it is estimated that 79 per cent of ETF holdings are US-sourced funds; 17 per cent UK/European- based funds).⁶⁷

⁶⁶ Financial Services Authority (2007): Growth in commodity investment: risks and challenges for commodity market participants.

⁶⁷ Ibid.

Figure 3: Breakdown of UK and European ETF investors

THE GROWTH OF THE MARKET

C.20 With the number of contracts trading on LME increasing by over 20 per cent between 2004 and 2006, and by 160 per cent for ICE Futures Europe over the same period, it is worth taking stock of the growth of the commodity derivatives market, so as to consider where commodity derivative markets may be heading.

C.21 This section therefore looks at the:

- recent growth of the derivatives market, and in particular, the growth of the commodity derivatives market;
- broader developments that are anticipated in the commodity derivatives markets.

Recent Growth Trends

C.22 **Derivatives** - as at December 2006, the notional outstanding value of OTC derivatives contracts stood at \$415 trillion, a 40 per cent increase on the 2005 figure. For exchange-traded derivatives, the equivalent figure was \$70 trillion, an increase of around 20 per cent on the position in 2005. For the OTC market, the UK is the dominant venue, capturing around 40 per cent of the OTC market share by average daily turnover, followed by the USA with just under a quarter of the market. As far as the on-exchange market is concerned, the Chicago Mercantile Exchange is by far the largest by notional value of contracts, with 46 per cent of global turnover. The UK sits in fourth place after

the USA, Korea and Germany for the number of derivatives contracts traded on exchange.⁶⁸

C.23 Commodity derivatives - the OTC and on-exchange markets in derivatives continue to be dominated by interest rate and foreign exchange contracts. Commodities derivatives represented only a small part of the estimated \$415 trillion of outstanding OTC derivatives contracts at the end of 2006, increasing their share to 1.7 per cent (up from 0.6 per cent in 2004). Still, the increased contribution of commodity derivatives is noteworthy when seen in absolute terms: between 2004 and 2006 the notional value of outstanding of OTC commodities derivative increased almost five-fold to reach \$6.9 trillion. The increase in on exchange trading in commodity derivatives has also been marked, with the number of outstanding contracts doubling between 2005 and 2006 to reach 36.4 million contracts.⁶⁹

Anticipated Developments

C.24 Changing relative importance of different product classes - over recent years the relative importance of different commodity derivatives has changed. For example, the significance of gold derivatives has declined from around a quarter of all OTC commodity derivatives contracts in 2002 to just 7 per cent in 2006. Oil and natural gas derivatives have been the drivers of growth in the market as energy prices have risen – indeed, the size of the UK power market in terawatt hours increased 52 per cent between July 2006 and July 2007.⁷⁰ It is highly likely that the energy market will continue to be a key driver of growth, particularly as China and India seek to satisfy the increased energy requirements associated with their rapid growth.

C.25 Product innovation – product innovation is expected to continue. As recent experience in the plastics market has shown, establishing new on-exchange contracts will continue to pose a significant challenge, and success is far from guaranteed.

C.26 Trading venues – despite innovation in on-exchange contracts, the OTC market looks set to maintain its hold on commodity derivatives, particularly for those active in the primary market. This reflects the numerous variables associated with the specifications, transporting and storage of the underlying physical stock. Still, the fact that virtually every worldwide commodity exchange now offers electronic trading will certainly provide for considerable further growth in on-exchange trading. Further consolidation of existing exchanges is expected as individual players seek to expand their platform and the breadth of services they can offer.

C.27 Investors – the development that is most likely to change the balance between the OTC market and on-exchange trading is the rise of ETFs and index-linked products, and the associated interest of institutional investors in commodity derivatives. An increasingly broad range of participants, including pension funds, retail asset managers, insurance companies and hedge funds will seek to gain exposure to commodities through such instruments.

⁶⁸ International Financial Services Limited (2007): Derivatives 2007.

⁶⁹ BIS Quarterly Review, March 2007

⁷⁰ International Financial Services Limited (2007): Derivatives 2007

CONSOLIDATED LIST OF QUESTIONS

Wherever possible we would welcome clear factual or quantitative evidence.

Chapter 3

Q1 – Do you agree that these are appropriate UK objectives for the review? If not, what objectives would you support?

Q2 – Do you agree that the better regulation principles are appropriate and necessary for the Review?

Chapter 4

Q3 – Do you agree that specialist commodity derivative firms generally pose limited risk to the financial system? If not, why and can you provide evidence to support this?

Q4 – Do you agree that there are information asymmetries leading to mis-selling concerns in commodity derivative markets? If not, why and can you provide evidence to support this?

Q5 – Do you have any evidence of information asymmetries in relation to market transparency?

Q6 – Do you have any evidence of information asymmetries in relation to market abuse?

Chapter 5

Q7 – Do you see benefit in retaining a bespoke regime for energy firms? If not, why not?

Q8 – Do you see a case for extending it to become a wholesale only regime? If not, why not?

Q9 – Do you agree that different rules in UK have not produced commercial distortions? If not, why and can you provide evidence to support this?

Q10 – Is the UK instrument boundary appropriate? If not, why and can you provide evidence to support this?

Q11 – Is the UK approach to transparency appropriate? If not, why and can you provide evidence to support this?

Q12 – Does the CESR compromise to MiFID transaction reporting address your concerns? If not, why and can you provide evidence to support this?

Chapter 6

Q13 – Do you agree that the dealing on own account exemption in Article 2(1)(i) should be retained?

Q14 – Do you agree that the services in commodity and exotic derivatives to clients of your main business exemption in Article 2(1)(i) should be removed? If not, why and can you provide evidence to support this?

Q15 – In practice are there any firms that would be brought within MiFID scope were the services in commodity and exotic derivatives to clients of your main business exemption in Article 2(1)(i) to be removed? If so can you identify those firms and the likely cost for them of compliance with MiFID?

Q16 – Do you agree that the exemptions in Article 2(1) (k) should be removed? If not, why and can you provide evidence to support this?

Q17 – Are there any firms engaging in own account dealing in commodity derivatives that might inappropriately be denied the Article 2(1)(d) exemption e.g. because they might be considered to be a market maker. And if such firms exist would the dealing on own account exemption of Article 2(1)(i) apply to them?

Q18 – In practice, if Article 2(1)(k) was removed would any firms be brought within MiFID scope as a result? If so can you identify those firms and the likely cost for them of compliance with MiFID?

Q19 – Do you agree that were UK proposals regarding the MiFID commodity exemptions enacted, firms engaging in such hedging activity would nevertheless be excluded from MiFID? If not, why not?

Q20 – In practice would any firm lose the ability to rely on the UK's Exemption Order were the exemptions in MiFID articles 2(1)(i) and (k) to be removed? If so who?

Q21 – Do you agree that MiFID client categorisation needs altering? If so, do you have any suggestions as to how it should be altered?

Q22 - Do you agree that a differentiated capital regime would offer sufficient protection to specialist firms? Do you have any suggestions as to what such a regime might look like? Do you have any quantitative evidence on the likely cost of compliance with full CRD?

Q23 – Do you have any evidence of level playing field problems?

Q24 - Do you have any further changes that you would want to see to capital requirements for mainstream firms in relation to commodity derivatives business? If so, what?

Q25 – What are your views on the Pillar 2 type approach put forward by a section of industry?

Q26 – Do you agree that a bespoke concessionary regime is a proportionate approach to the regulation of firms who only engage in energy commodity investment activities and services? Why and do you have any suggestions as to what it would look like?

Q27 - Do you think this approach is suitable for a wider range of firms? If not, why and can you provide evidence to support this?

Q28 – Do you agree that the definition of a financial instrument remains appropriate? If not, why and can you provide evidence to support this?

Q29 – Do you have any evidence of instruments whose position is unclear in the current terminology?

Q30 – Do you have any evidence of problems in relation to transparency in the derivatives market?

Q31 – Do you agree that commodity derivatives should be removed from the scope of the MiFID transaction reporting regime? Why?

Q32 – Do you see benefit in position reporting? Why?

Q33 – Do you agree that market abuse issues are better looked at in the EU's market abuse review? HM Treasury and FSA would nevertheless be interested in any strong views on desirable changes to help prepare for said review?

E

CONSULTATION LIST

Industry

ABN AMRO BANK

AMALAGAMATED METALS CORPORATION GROUP

APX GROUP

ARMAJARO GROUP

BANQUE AIG

BALTIC EXCHANGE AND FORWARD FREIGHT AGREEMENT BROKERS ASSOCIATION

BARCLAYS CAPITAL

BNP PARIBAS COMMODITY FUTURES LIMITED

BP PLC

BRITISH ENERGY

CALYON

CENTRICA

CHEVRON

CITIGROUP

CLARKSON SECURITIES LIMITED

CONOCOPHILLIPS

CREDIT SUISSE

CZARNIKOW GROUP

DELOITTE

ED&F MAN COMMODITY ADVISERS

EDF

EURONEXT LIFFE

EXXONMOBIL

FIMAT

FLEISHMAN

FORTIS BANK

GALENA INVESTMENT

GFI

GOLDMAN SACHS
HETCO
HSBC
ICAP
ICE FUTURES
INTERNATIONAL POWER PLC
JP MORGAN CHASE
KOCH INDUSTRIES
LCH.CLEARNET
LEHMAN BROTHERS INTERNATIONAL
LONDON METAL EXCHANGE
MACQUARIE BANK
MAREX FINANCIAL
MERRILL LYNCH
MORGAN STANLEY
NATIXIS COMMODITY MARKETS LIMITED
PRICEWATERHOUSE COOPERS
RABO BANK
ROYAL BANK OF CANADA
ROYAL BANK OF SCOTLAND
RWE
SCOTIA CAPITAL
SCOTTISH POWER
SEMPRA METALS
SPECTRON
STANDARD BANK
STANDARD CHARTERED
STASCO
SUCDEN
UBS

Trade Associations

ASSOCIATION OF ELECTRICITY PRODUCERS

FUTURES AND OPTIONS ASSOCIATION
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION
LONDON INVESTMENT BANKING ASSOCIATION
WHOLESALE MARKETS BANKING ASSOCIATION

Government, Central Banks and Regulators

BANK OF ENGLAND
CABINET OFFICE
DEPARTMENT OF BUSINESS, ENTERPRISE AND REGULATORY REFORM
FINANCIAL SERVICES AUTHORITY
HM TREASURY
OFFICE OF FAIR TRADING
OFFICE OF GAS AND ELECTRICITY MARKETS

Law Firms

ASHURST
BERWIN LEIGHTON PAISNER
CLIFFORD CHANCE
DENTON WILDE SAPTE
FRESHFIELDS
HERBERT SMITH
LINKLATERS
LOVELLS
NORTON ROSE
SIMMONS & SIMMONS
SLAUGHTER AND MAY
TRAVERS SMITH

Universities

CITY UNIVERSITY LONDON
LONDON SCHOOL OF ECONOMICS

F

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- Point Carbon (2006): Carbon 2006, Towards a truly global market, http://www.pointcarbon.com/wimages/Carbon_2006_final_print.pdf

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