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M E M O R A N D U M

TO: Joint Associations' Working Group on Commodity Firms' Regulatory Capital Treatment (CFRC Working Group)

FROM: EFET; FOA; ISDA; Energy Commodities Traders Group; [LIBA]

DATE: 16 September 2005

RE: **CFRC Working Group- Terms of Reference**

The purpose of the following Memorandum is to set out the terms of reference of the Joint Associations' Working Group on Commodity Firms' Regulatory Capital Treatment (CFRC Working Group).

Background

Commodity firms active in the EU are currently subject to capital requirements determined at the national level. For instance, in the UK, oil and energy producers benefit from a "light touch" regime. This situation may change if these firms become authorized investment services providers under the Markets in Financial Instruments Directive ("MiFID"), scheduled for implementation in 2007. At present, Article 2.1 of MiFID exempts commodity firms providing investment services in commodity derivatives as an ancillary service (2.1(i)), as well as firms whose main business consists in dealing on own account in commodities/commodity derivatives (2.1 (k)). However, these exemptions are to be reviewed in 2007, and could disappear or be amended substantially, with the result that commodity firms currently exempted under Articles 2.1 (i)/ 2.1 (k) may eventually have to comply with MiFID, and also, by implication, with the Capital Requirements Directive ("CRD").

The CRD sets out the regulatory capital treatment of financial institutions. At a political level in the EU, it is felt that this Directive might not offer a suitable framework for determining commodity firms' regulatory capital needs. This concern has inspired one particular amendment to the CRD draft text in the European Council : "the capital requirements, and other prudential rules, applied to firms active in those [i.e., commodity] markets need to be proportionate and should not unduly interfere with achievement of the goal of liberalization [of gas and electricity markets]."

Commodity firms are given a unique opportunity to negotiate the capital standard which they believe should apply to their activities, between now and the date retained for the potential withdrawal of the MiFID exemptions (currently, October 2007). The EU Commission is planning to establish a working group, composed of the representatives of relevant EU regulatory bodies, no later than early next year. This working group will be tasked with assessing the need for adopting a differentiated capital treatment for commodity firms and will aim to conclude by mid 2007.

The UK FSA has established a commodity firms' working group to discuss, in particular, the capital treatment of firms currently exempt under MiFID. This working group intersects with the CFRC Working Group extensively, which will ensure a good degree of co-operation and cross fertilisation between the two groups.

Objective

The CFRC Working Group is the joint initiative of the European Federation of Energy Traders (EFET), the Futures and Options Association (FOA), the International Swaps and Derivatives Association (ISDA), the London Investment Banking Association (LIBA), and the Energy Commodities Traders Group to provide an international industry platform for discussing the regulatory capital treatment of commodity firms active in the EU.

A key objective for the CFRC Working Group is to **develop a proposal for a harmonised and proportionate capital treatment of commodity firms active on a cross border basis in the EU**. This proposal will be shared with national regulators and the EU Commission and will constitute the EU industry's opening bid in future negotiations with rulemaking bodies.

Considering the EU Commission's timeframe mentioned under "Background" above, it would be ideal to **have a complete proposal ready, ideally by June/July 2006**. Specific elements of the proposal and high level messages agreed upon by the group may be shared with the Commission and the regulators before June 2006.

Issues for discussion can be divided into two sets:

-general matters : scope of application of the new capital framework; global solvency standard for commodity firms.

-specific issues: treatment of each of the main risk types, market, credit and operational risk.

The CFRC Working Group should consider the opportunity of establishing sub-groups, each focused on a particular risk type. These sub-groups would use past documents produced by the

Associations as a starting point. Relevant documents are being collated in a CFRC Compendium 2005, which will be available on the Associations' websites (www.isda.org, www.foa.co.uk, www.efet.org, www.liba.org.uk), and in paper form.

Calendar of meetings [next three meetings]

19 October 2005	Scope of proposed capital treatment First draft : Chris Bates Presentation : FOA [TBC]
November 2005	Market Risk Presentation and first draft : Martin Spanier and Tobias Strothman
December 2005	Overall calibration of capital charge and credit risk Presentation and first draft : Emmanuelle Sebton and Martin Spanier

Composition of the Working Group : Risk Officers from major commodity firms active in the EU, with expertise in the field of credit, market, or operational risk [list of participants attached.]

Frequency of meetings : monthly. Held either in person or by conference call. Organiser : ISDA

Contact persons: Martin Spanier (EFET, Martin.Spanier@syneco.net), Joerg Sperling (EFET, joerg.sperling@rwe.com) Jane Green (FOA, GreenJ@foa.co.uk), Emmanuelle Sebton (ISDA, esebton@isda.org).

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