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Mr Peter Smith
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27 January 2006

Dear Peter

Review of regulatory capital treatment of commodity firms

I am writing to you on behalf of the Joint Associations' Working Group on Commodity Firms' Regulatory Capital Treatment.

The 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) and the Energy Commodities Traders Group. It aims to provide an international industry platform for discussing the regulatory capital treatment of commodity firms active in the EU. The members of the Working Group are mainly risk officers from major commodity firms active in the EU, with expertise in the field of credit, market or operational risk. A list of the members of the Working Group is set out in the attachment to this letter.

The purpose of this letter is to request the Commission, before it begins its review of the regulatory capital treatment of firms active in commodity and commodity derivative markets mandated by the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive (CRD),¹ to set out clearly the reasons why it decided, at the outset, that it was necessary to impose prudential and regulatory capital requirements on commodity firms, i.e. those firms brought into the scope of the EU licensing regime for the first time by the extension of the scope of MiFID to include activities relating to commodity derivatives.² Put another way, is the Commission satisfied that its original decision is appropriate and proportionate, fulfils the objectives of the Lamfalussy principles, is justified by market impact analysis and is consistent with the Commission's "better regulation" policy objectives?

In addition, the Working Group urges the Commission to ensure that its review re-examines the objectives that any prudential or regulatory capital regime might aim to achieve and the question of whether it is, in fact, necessary to impose any such regime on this class of firms at all.

¹ Under article 65(3) MiFID and article 45d(2) of the Capital Adequacy Directive (CAD), as recast by the CRD.

² I.e. those derivative contracts referred to in Annex 1 Section C points 5, 6, 7, 9 and 10 of MiFID.

The Working Group also urges the Commission not to limit its review of prudential and regulatory capital requirements to their impact on the narrow class of those firms whose main business consists exclusively of the provision of investment services or activities in relation to commodity derivatives (or those whose main business is dealing on own account in commodity derivatives). It should consider their impact on all firms that are potentially brought within the scope of EU licensing requirements for the first time by the extension of the scope of MiFID to cover activities relating to commodity derivatives, including those whose main business is dealing in both commodities and commodity derivatives and those affected by any proposal to modify the exemptions in article 2 MiFID.³

Commodity firms do not present the same investor protection or systemic risk as banks and securities firms

The Working Group is particularly concerned to ensure that the Commission clearly articulates its reasons for proposing the application of prudential and capital requirements, as the conventional arguments for regulatory intervention in the financial sector - to protect clients or to mitigate systemic risks - do not apply to commodity firms.

Regulation makes sense in some markets on the grounds of *investor protection*. The failure of an individual firm may cause loss to clients or counterparties of the firm and those clients or counterparties ought to be protected against that loss because they are not readily able to judge the safety and soundness of the firm and are thus incapable of protecting their own interests. However, these arguments carry little weight in the case of commodity firms that participate in wholesale markets. These firms do not take deposits from the public. Nor is there any protection scheme or lender of last resort providing a safety net against failure which needs the protection of a regulatory capital regime.

These firms trade in commodity and other non-financial derivatives with wholesale market participants who should be in a position to assess the credit-worthiness of their counterparties.

Indeed, imposing a regulatory capital regime risks creating an impression that there is an implicit safety net which itself can give rise to moral hazard.

Regulation may also make sense in some markets because the failure of an individual firm may have adverse effects on *systemic stability*. However, there is little evidence that the failure of members of this class of commodity firms is likely to have that effect. Some of these market participants may be part of larger groups of a significant size (e.g. large oil companies or power generators). It is unrealistic to expect the securities or banking regulator to seek to monitor or control the risks in such a group as a whole, even if it were desirable. Indeed, the most significant recent failure, Enron, did not have systemic impact, notwithstanding its scale.

To the extent that these entities participate in energy storage or transmission networks, the banking or securities regulator is likely to be ill-equipped to supervise the activities of market participants. The relevant energy market regulator is likely to be better placed to do this.

³ Under article 65(3) MiFID

In any event, there is little to indicate that these markets have the characteristics of other markets where the risk of systemic damage is so significant to justify intervention. These commodity firms do not have the unique balance sheet structure of banks or the pivotal role that banks have in the payments system, which could serve as a means to transmit the consequences of a collapse into other market segments. Indeed, in markets such as power or energy markets, a generator or producer that becomes insolvent is likely to continue to operate, and to fulfil its core supply obligations, under protection from its creditors, thus further weakening any possible link between firm default and systemic consequences.

Unintended consequences

The introduction of regulatory capital requirements may have significant unintended consequences:

- Any regulatory capital regime is likely to impose significant costs on an ordinary commercial or industrial enterprise with other assets and liabilities. So the imposition of such a regime is liable to lead to the "push out" of regulated activities into a separate regulated trading subsidiary. For many producers, users, manufacturers, generators, etc. of commodities, their activities in physical markets are a natural offset to their commodity derivatives business. Forcing such firms to subsidiarise their commodity derivatives business may in fact make it more difficult for them to manage risk, particularly if the regulated subsidiary is limited in the extent to which it can lay off risks with its other group companies by limits on intra-group large exposures.
- Similarly, it is likely to lead to those groups seeking to carry out activities in non-EU markets from outside the EU on the basis that this is cheaper and less burdensome.
- In addition, if there are significant regulatory capital rules, on top of licensing requirements, this is likely to create additional obstacles to non-EU entities wishing to participate in EU markets, thus reducing competition in those markets. While non-EU groups can make use of EU booking vehicles to trade in EU markets, laying off those risks through back-to-back or similar contracts or arrangements may be made more difficult by regulatory capital rules.

No need for regulation to try to create "level playing field"

Moreover, the mere fact that some banks and securities firms which trade in these markets are the subject of comprehensive regulatory supervision does not justify the introduction of comparable rules for commodity firms which pose very different risks to the system, have essentially wholesale counterparties/customers and carry on a very different underlying business.

The Working Group considers that proportionate and risk-based regulation should give full recognition to the matters set out above, the very different nature of commodity markets (and their economic purpose) and the significant differences in the quantum and type of risks faced by users of those markets, as compared with retail investors and savers. These fundamental differences have led the Working Group to question whether it is necessary or desirable to impose a prudential or regulatory capital regime on commodity firms. Such a regime is also likely to be unique to the EU insofar as other jurisdictions (in particular, the United States) are not currently seeking to impose similar prudential requirements on this category of market participant. As you will appreciate, this has significant implications for the competitiveness of EU-based commodity firms.

It is for these reasons that the Working Group asks the Commission clearly to articulate the regulatory objectives, to identify the risks addressed and to set out the supporting analysis and data that led to its decision to extend prudential regulation in this way. This information would also help ensure that responses made to the Commission as part of the forthcoming review are properly informed and focus on the reasons, data and evidence identified by the Commission as supporting its argument for the need for prudential regulation of commodity firms.

We look forward to receiving your response to this letter in due course. In the meanwhile, if you have any question or comments on this letter or would like to understand further the view of the Group, please contact Emmanuelle Septon, Anthony Belchambers or Martin Spanier at esepton@isda.org; belchambersa@foa.co.uk; or martin.spanier@syneco.net.

Yours sincerely,



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**JOINT ASSOCIATIONS' WORKING GROUP ON COMMODITY FIRMS' REGULATORY CAPITAL
TREATMENT**

PARTICIPATING ASSOCIATIONS

European Federation of Energy Traders (EFET)
Futures and Options Association (FOA)
International Swaps and Derivatives Association (ISDA)
Energy Commodities Traders Group

MEMBERS OF THE WORKING GROUP

Accord Energy (Centrica)
Amalgamated Metals Trading
Becker Buttner Held
BP
Clifford Chance
ConEnergy
ConocoPhillips
E.ON Sales & Trading
ED & F Commodity Advisors Limited
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