

# EU Commodity Markets and Trading: An Introductory Workshop

Lynn Johansen  
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**C L I F F O R D**  
**C H A N C E**

Alternative Approaches for  
Financial Market Supervision

# Alternative Approaches for Financial Market Supervision

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- Introduction
- Outline of framework for supervision of commodity trading in the USA
- Outline of framework for supervision of commodity trading in Switzerland

# Alternative Approaches for Financial Market Supervision

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## ■ Introduction

- Talk designed to illustrate that there remains a lack of convergence regarding policy and detail regarding regulation of commodity derivatives
- This poses problems:
  - Lack of intellectual coherence leads to greater difficulties in creating compliance culture
  - Regulatory arbitrage
  - Inhibition of competition
- Transnor case is an illustration of what can happen if regulation is not coherent
- US regulatory trend is now in opposition to EU's regarding commodity (and other) OTC derivatives

# Alternative Approaches for Financial Market Supervision - USA

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- Outline of framework of supervision in USA for trading in
  - Physical spot and forward transactions
  - All types of derivativesinvolving non-financial underlyings such as energy, metals, emissions and agricultural commodities

# Alternative Approaches for Financial Market Supervision - USA

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- Spot transaction is not defined but is generally regarded as a
  - Bilateral transaction
  - To buy and sell for settlement
  - Within 2 days or less
- Forward transaction is
  - Bilateral transaction
  - To buy and sell for settlement
  - In more than 2 days
  - Not standardised or so standardised that parties are trading in the contract rather than the underlying commodity
- Forward transactions may be settled by an offsetting transaction

# Alternative Approaches for Financial Market Supervision - USA

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- Spot and forward transactions in commodities are NOT derivatives
- As a rule, neither spot and forward transactions in commodities, nor those who deal or advise in respect of them, are subject to any comprehensive scheme of regulation
  - No licensing or regulatory capital requirements
- Exception is in respect of energy (particularly power) where certain non-market regulation applies

# Alternative Approaches for Financial Market Supervision - USA

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- Dealers in power must become registered with the Federal Energy Regulatory Commission (FERC) as power marketers
  - Requirement does not apply to generators or transmitters of power
  - No FERC minimum capital requirements

# Alternative Approaches for Financial Market Supervision - USA

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- US market regulation distinguishes between exchange-traded and OTC derivatives

## EXCHANGE TRANSACTIONS

- Futures and certain options on commodities traded on public markets, however settled, are subject to comprehensive federal regulations
- The Commodity Exchange Act, administered by the Commodity Futures Trading Commission (CFTC) regulates exchanges and brokers and advisers in respect of
  - Standardised commodity futures and options contracts
  - Traded on multi-lateral transaction execution facilities (exchanges)

# Alternative Approaches for Financial Market Supervision - USA

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- Commodity futures and options transactions must be traded on or through a CFTC approved and supervised exchange (or in some instances, on a foreign exchange) and through a broker
  - Exception from this rule relates to non-agricultural commodity futures and options entered into between parties meeting specified financial criteria
- It is generally prohibited for a person to act as a dealer in commodity futures and options

# Alternative Approaches for Financial Market Supervision - USA

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- Exchanges (“designated contracts markets”) that offer trading to the general public are subject to the highest regulatory oversight. All transactions made on a DCM must be cleared through a designated clearing organisation
- Exchanges which are only open to limited, sophisticated traders are subject to lesser regulatory oversight

Both are subject to statutory core principles relating to market integrity, fair dealing and prevention of market abuse but fixed capital requirements do not apply

# Alternative Approaches for Financial Market Supervision - USA

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- Brokers must be “licensed” as a futures commission merchant or introducing broker. They are subject to
  - Disclosure
  - Record keeping
  - Customer protection requirements, including rules relating to protection of client property
  - Financial requirements
- FCM’s capital requirements are based on the amount of customers’ funds and property held as well as a fixed minimum level
- IB’s must meet a (modest) fixed minimum capital requirement

# Alternative Approaches for Financial Market Supervision - USA

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- Advisers and operators of collective investment vehicles involving commodity futures and options must be licensed. No capital requirements apply.

## OTC transactions

- Most wholesale OTC commodity derivative transactions are NOT regulated
- Exceptions to this rule are
  - Transactions on agricultural products or their prices
  - Transactions between parties who do not meet the statutory set professional or financial standards to qualify as “Eligible Contract Participants” (ECPs)

# Alternative Approaches for Financial Market Supervision - USA

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- ECPs include banks, insurance companies, regulated investment companies, commodity funds, entities and individuals with more than \$10 million in total assets (or having \$1 million in net assets in the case of risk managers) employee benefit plans with more than \$5 million in assets, broker dealers, government entities, FCMs, investment managers.
- CFTC can add to the list of who qualifies as an ECP.

# Alternative Approaches for Financial Market Supervision - Switzerland

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- Swiss law adopts slightly different approach to US law as regards the boundary of regulation but also draws a distinction between exchange traded and OTC derivatives.
- Spot transactions in commodities are not regulated. Exception to this is trading in precious metals
  - No definition of spot transaction: determined by market practice

# Alternative Approaches for Financial Market Supervision - Switzerland

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- The Swiss Stock Exchanges and Securities Trading Act (SESTA) defines a derivative to be a financial contract whose price derives from a financial asset
  - Commodities are included as an underlying asset
  - Exchange traded and OTC transactions are included within the definition of a derivative
- SESTA only imposes regulation on transactions in derivatives which are standardised to a large degree
  - “standardised” means that the transactions are available to the public (more than 20 investors) and have a uniform structure/denomination
  - These are treated as securities under Swiss law

# Alternative Approaches for Financial Market Supervision - Switzerland

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- Non-standardised derivative transactions are not subject to regulation
  - Therefore if created for an individual counterparty, transaction would not be regulated
- Broadly OTC transactions are not regulated (although some may be)
- Financial institutions who deal in or act as broker for a client in respect of commodity derivatives which are offered to the public are “derivatives houses” and must be regulated as a securities dealer
- No licence is required if deal on own account unless deal in volumes of over CHF 5 billion per year

# Alternative Approaches for Financial Market Supervision - Switzerland

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- Only those that deal in or broker exchange traded derivatives or create a standardised OTC derivative which is offered to the public must be licensed
  - Subject to organisational and prudential and fitness and properness tests
  - Minimum capital of CHF 1.5 million
- Money laundering regulations apply to commodity transactions entered into on an exchange for a client or for own account (if the trading by the relevant entity exceeds the CHF 5 billion threshold)
- Any form of trading in precious metals is subject to Swiss money laundering regulations

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