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

**ISDA-FOA-EFET Response**

ISDA, the FOA and EFET welcome the opportunity to respond to the discussion paper of HM Treasury and the Financial Services Authority.

These organizations have been cooperating as parts of the Commodity Derivatives Working Group (CDWG) and Commodity Firms Regulatory Capital Working Group (CFRC WG), to engage in the EU review of commodities regulation as mandated under MIFID and the CRD. The members of these working groups are mainly risk officers, compliance officers, and lawyers from major commodity firms active in the EU, with expertise in the field of credit, market or operational risk.

*Where we use the term 'CDWG' in this submission, we are referring to the view jointly held by each of these associations regarding the principles of financial regulation of commodity firms and specifically in relation to the questions put by HMT and the FSA in the Discussion Paper.*

ISDA represents participants in the privately negotiated derivatives industry and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

The FOA is the industry association for 160 international firms and institutions which engage in the carrying on of derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector.

EFET is an organisation designed to improve the conditions of energy trading in Europe and works to promote the development of a sustainable and liquid European wholesale market. EFET is complementary to existing industry organisations in Europe as it is solely dedicated to energy trading issues, and lists over 50 firms as members.

The CDWG has previously provided responses to the ongoing Commission review of commodities business and the current MIFID and CRD exemptions for commodities firms. These include a detailed response to the Commission in May 2007 (which incorporated the proposed bespoke prudential regime we refer to as the “Alternative Approach”) in response to the December 2006 Call for Evidence, and the response to the recent CESR/CEBS Call for Evidence.

## **Background**

The CDWG starts from the premise that the conventional arguments for regulatory intervention in the financial sector - to protect clients or to mitigate systemic risks – do not apply to commodity firms. The arguments made for regulating the financial sector are of little relevance to commodity firms who participate in wholesale markets and trade in commodity and other non-financial derivatives with wholesale market participants who should be in a position to assess the risks inherent in the transactions they enter into. The commodity firms they deal with 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. 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. Furthermore there is very little evidence that the failure of a commodity firm poses any financial systemic risk. 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 markets, a generator or producer that becomes insolvent is likely to continue to operate, and to fulfill its core supply obligations, under protection from its creditors, thus further weakening any possible link between firm default and systemic consequences.

It was on this basis that in 2006 we wrote to the European Commission (letter dated 21/01/06) to encourage a re- examination of the objectives that any prudential or regulatory capital regime might aim to achieve. We also argued that disproportionate regulation could have unintended consequences, and that due to the very different nature of the risks involved, proportionate and risk-based regulation should be considered in place of regulation merely designed to create “a level playing field”.

In 2007, in response to the European Commission’s first call for evidence (published in December 2006), we outlined our view of how trading of commodity derivatives and commodities should be regulated. We also requested any new regulation in the commodity derivatives and commodities trading markets be justified by rigorous cost-benefit analysis and impact assessment, as well as lengthy and broad consultation.

We welcome this opportunity to contribute to the thinking of HM Treasury and the FSA, and hope that this response to the Discussion Paper will usefully inform the FSA approach to the current CESR-CEBS discussions.

In responding to this Discussion Paper, we have set out our core concerns in the Executive Summary. We also include a number of annexes detailing previous submissions, including our recent submission to CESR and CEBS, which includes the “Alternative Approach” to prudential

regulation, which we consider to be one of the appropriate regulatory policy options that should be discussed.

## **Executive summary**

The CDWG believes that the current review of regulation of commodity and exotic derivatives should result in a framework based along the following lines:

- *Retention of an exemption from MIFID for own account trading between professional investors. In this context, the definition of ‘professional’ would need to be revisited, with a view to adapting it to the realities of the commodities market where many professional participants in these markets would currently fall outside the scope of the current MIFID classification.* The CDWG believes that the investor protection concerns built into MIFID conduct of business rules are not pertinent in markets which are sophisticated and wholesale in nature, with no direct retail involvement. The CDWG also strongly believes that if there is support for the idea of exempting from MIFID own account trading by commodity firms with professional counterparts, efforts should be concentrated on retention of exemptions (i) and (k) – or amended versions therein – rather than ‘expansion’ of exemption (d) – to avoid any confusion or unintended consequences that may result from altering an established exemption.
- *Application of an ‘appropriate’ licensing regime for activities of commodity firms other than own account trading (such as portfolio management).*
- *An ‘appropriate’ capital regime (“the Alternative Approach”), based primarily on internal risk management models and disclosure (rather than Pillar I minimum capital requirements), applying to firms’ activities which fall within the scope of the ‘appropriate’ licensing regime mentioned above.* The CDWG feels that it is particularly important to emphasize the major concerns that commodity firms have about the potential scale of capital requirements applied to them in event of a MIFID licensing requirement, whatever the limits of the final MIFID regime. We believe the Alternative Approach should be considered as the minimum standard for MiFID commodities firms where Pillar 1 capital requirements are considered disproportionate to the risks and where the costs are likely to significantly outweigh the regulatory benefits. Members of the CFRC working group are considering how best to provide some information on Pillar 1 impacts, and we would hope to share with CESR/CEBS, the European Commission and HMT/FSA the output from any such initiative later in the year. A disproportionate capital regime for commodity firms who pose limited financial systemic risk would, we believe, have a disastrous effect on commodities markets.
- *The retained exemption for own account trading between professional investors should be applied in a harmonized way throughout the EU.* A focus on delivering harmonized implementation of such an exemption will, in our opinion, benefit the EU single market, delivering economies of scale for market participants, greater competition, and lower commodity prices for end-users.
- No change to the current definitions of commodity derivatives.

- No financial regulation of ‘physical’ commodities business – which has a very different purpose to commodity derivatives business.

### Chapter 3 - Objectives for the Review

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

The CDWG agrees that the objectives highlighted by the paper are generally appropriate for the review. Certain of the objectives are of particular significance to members of the CDWG and certain other objectives might also bear consideration.

The need to increase the *global competitiveness* of EU firms is an important one. The CDWG maintains that new regulation and associated costs for the market in commodity derivatives should not have net negative effect on the market (for example regulation should not lead to firms having to significantly restructure their business or remove fixed assets such as oil/gas fields, thereby creating less valuable and integrated trading vehicles, or to establish their businesses in countries outside the EU, thus undermining integration, participation and market liquidity). Where new regulation is proposed it should be clear that the associated costs should not outweigh the benefits.

We feel strongly about the importance of *market integration*, and the need to develop a harmonized approach that enables commodity firms to take advantage of a true single market. It is our view that this will promote market liquidity: the establishment of open rights of access and regulatory proportionality are critical to achieving this objective.

The CDWG is particularly concerned with arguments which suggest the elimination of differences in treatment between market participants, referring to the need for a *level playing field*.

The CDWG believes that a “level playing field” is more about open rights of market access and the avoidance of market rules which prejudice the competitiveness of differentiated market participants. In applying that interpretation of what is meant by a “level playing field”, regulatory “harmonisation for harmonisation’s sake”, which pays insufficient regard to the *need for proportionality*, actually undermines the competitive position of specialist firms operating solely in a specialist market (where, for example, reduced risk justifies commensurate reduction in required capital) as against those market participants which operate across a diverse range of markets (e.g. financial institutions). Such disproportionate regulatory treatment has the effect of delivering an unlevel “playing field”, is tantamount to protectionism and runs contrary to free and open market access principles.

We note also the comments made in the HM Treasury/FSA response to Question 10 of the Commission’s call for evidence, dated 30<sup>th</sup> April 2007, that:

*“Regulation only brings economic benefits where it addresses a market failure. Where the intention of adding regulatory burdens is solely to create a “level playing field”, it will give rise to net economic costs.”*

The CDWG believes that commodity firms should be able to take advantage of a level playing field in terms of regulation in each Member State across the EU, with equivalent rules implemented and applied in every EU Member State.

We note that the comments of the European Commission on a *level playing field* seem to assume that financial regulation is the main possible cause for discrimination, and that all participants in the commodity derivatives markets are “involved in the same activities”. We underline that there are different issues, completely independent from financial regulation and the implementation of MIFID, which undermine the development of a level playing field for these physical commodities.

*While we agree that investor protection is a worthy goal of regulation, we do not feel that it has much relevance in these largely wholesale, professional markets*, where maintenance of “clean, fair and orderly markets” would be a more beneficial goal for market participants.

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

The *CDWG strongly agrees with the use of better regulation principles* in undertaking this review.

However, we highlight the need for regulators to justify the need for intervention by demonstrating that additional regulation is required to address a market or regulatory failure. Without the evidence of such a failure the CDWG does not believe that additional regulation can be justified, and even in the event that intervention were to be justified, regulation should only be imposed to the extent that it addresses the causes and consequences of such a failure.

**Chapter 4 - Market Failure Analysis**

**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?**

The CDWG agrees with the views of both CEBS and HMT/FSA that *commodity firms pose limited systemic risk* to the financial system.

We refer you to our previous detailed submissions on the commodities sector, and in particular our letter to the EU Commission (dated January 2006) outlining why we believe the conventional arguments for regulatory intervention in the financial sector do not apply to commodity firms (annex 1), our response (annex 2) to the second part of CEBS proposed advice to the European Commission (dated August 2007), and our more recent response (annex 3) to CESR and CEBS on their call for evidence on commodities (dated March 2008).

**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?**

*The CDWG would like to make the point that no EU agency has established evidence of market failure concerning either mis-selling, transparency or market abuse in relation to commodity derivative markets (we do not believe the impact assessment carried out prior to the adoption of the proposals for the 3rd Energy Package amounted to a thorough, exhaustive or objective examination of the market).*

The CDWG acknowledges that some degree of information asymmetry is unavoidable in commodity markets given the involvement of some market participants in the underlying physical markets.

*We do not believe that information asymmetries are leading to **mis-selling** concerns in commodity derivative markets.*

The markets themselves are primarily wholesale markets, and counterparties, being both aware of the potential for asymmetries and having a high degree of industry expertise, are considered capable of protecting their own interests in this regard.

Where retail participation is a factor in commodity markets, it is not direct (i.e. it is managed by professional, regulated market participants). As such, we feel that, taking into account the definition of professional given in answer to Q21, and the exclusion of retail from the proposed exemption, retail participation should not be a focus of the EC's MiFID review.

We do not believe that there is any clamour from market participants for regulators to address supposed mis-selling in commodity derivatives markets, and suggest that this is sufficient evidence of the lack of a market failure therein.

*We agree that there is limited evidence to suggest that the naturally occurring information asymmetries mentioned above result in a sub-optimal level of **market transparency**.*

We welcome the reference in the discussion paper to the availability of commercial data services such as Bloomberg, Reuters and Platts, as well as consensus pricing tools. These data sources are sometimes overlooked in regulators' consideration of commodity market transparency.

We also remind HMT and the FSA that the proposals from the European Commission as part of the 3<sup>rd</sup> Energy Package address transparency in production of gas and electricity, imposing new transparency requirements on supply undertakings active in electricity and gas markets e.g. increased transparency on gas stocks, on forecasts of demand and supply and costs for network balancing. ISDA, the FOA and EFET support these requirements, as a helpful improvement to levels of physical market transparency which should inform the considerations of participants in derivatives markets.

HMT and FSA are aware of the European Commission-CESR-ERGEG Call for Evidence on transparency in commodity derivatives markets, to which the CDWG will be submitting a response.

In addressing the question on *market abuse*, we would make the general observation that derivative trading based on knowledge of the physical market should not generally be regarded as the inappropriate use of inside information. In many cases, market participants use derivative markets to hedge their physical position. Attempting to divorce these two areas would be counter to the purpose of the market, and would actually prevent firms from using commodity derivatives to hedge commercial risk.

Again, we would observe that the 3<sup>rd</sup> Energy package proposals should increase transparency around aspects of physical markets (see three paragraphs above). We support these proposals.

The Market Abuse Directive defines inside information in such a way as to recognise that commodity derivatives differ from others because of the absence of an issuer whose information can be misappropriated<sup>1</sup>.

We are aware that the 2007 European Securities Market Expert Group report on the implementation of the EU Market Abuse Directive concluded that “the definition of “inside information” adopted with respect to commodity derivatives does not appear to be aligned with the underlying market reality” and that the Committee of European Securities Regulators is beginning work on this issue in 2008. CDWG member associations will input into this discussion and on the wider EU Market Abuse Directive review.

While we are aware that there are some views in the banking sector that current market abuse rules applying to commodity firms are not sufficient, we understand that these concerns do not relate to information asymmetries per se.

## **Chapter 5 - UK financial regulatory regime**

**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?**

The bespoke UK OMP and EMP regime currently mitigates some of the impact of the broad regulatory scope of the general UK regime and so protects certain firms from what the CDWG believes would otherwise be a disproportionate regulatory burden. In that respect it has been helpful.

The CDWG has not discussed the idea of a broader-based wholesale regime for commodity derivatives trading (one not restricted to oil or energy firms), and as such, does not feel ready to pronounce an opinion on this issue.

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<sup>1</sup> From Article 1, EU Directive 2003/6 on insider dealing and market manipulation: “In relation to derivatives on commodities, “inside information” shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more such derivatives and which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets.”

In general, the CDWG believes that there should be a common approach across the EU to the licensing of specialist commodity firms. The CDWG believes that MIFID should exempt own account dealing between professionals and that this exemption should be applied in a binding way in all EU Member States. We believe, in principle, that any super-equivalent implementation of EU legislation should be clearly justified by competent authorities.

Commodity and other non-financial derivatives markets involve a wide range of market participants, whose business and risk profile is different from those involved in securities markets. A risk based approach to regulation should recognise those differences and treat different market participants differently when they present different risks to the FSA's objectives. To the extent that the current UK rules in this area acknowledge and reflect the differing risk profiles of market participants the CDWG agrees that they have not produced commercial distortions.

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

The UK regime is significantly broader in instrument coverage than MIFID.

In general, we believe that a consistent approach to implementation of MIFID across the EU is preferable for commodity firms. We believe, in principle, that any super-equivalent implementation of MIFID at national level should be clearly justified by competent authorities.

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

We agree that it is appropriate to focus attention on transparency for contracts traded on an exchange.

Overall transparency levels in the EU concerning the underlying market in electricity and gas should be enhanced by the proposals in the 3<sup>rd</sup> Energy Package applying to supply undertakings in these markets (see answer to question 5) – although we note that Ofgem rules on the use of physical power and gas infrastructure in the UK ensure a high level of transparency in the UK market in this regard.

We underline that OTC commodity derivative markets are wholesale in nature, and that the professional participants engaged in trading are both aware of the potential for asymmetries and have a high degree of industry expertise. They are capable of protecting their own interests in this regard. We believe that the levels of transparency apparent in this market reflect what the market feels is appropriate.

As mentioned in the Discussion Paper, commercial data services such as Bloomberg, Platt's, Argus and Reuters further enhance transparency in commodities markets, based on demand for such information from market participants.

*We believe that the UK approach to transparency is appropriate.*

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

The CESR approach addresses the concerns of members of the CDWG, for the purposes of implementation of the MIFID.

## **Chapter 6 - High-level policy options**

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

*All CDWG firms share the view that own account trading by commodity firms with professional counterparties should be exempted from MIFID.*

Based on the experience of applying the Directive in practice, some members of the CDWG also feel that the amendments to MIFID should preserve the first limb of article 2(1)(i) covering own account dealing in financial instruments as an ancillary activity to the firm's main business. This is an important exemption for these firms, in particular for those entities performing group treasury functions that deal on own account for hedging or investment services in any kind of MIFID financial instrument but that are unable to rely on Article 2(1)(d) because they also conduct other activities that may amount to investment services covered by other exemptions (e.g. advice or dealing activities on behalf of other group companies falling under Article 2(1)(b)).

Further detail on our position concerning exemption (i) is provided in our response to the following questions.

**Note:** We do not consider that the evidence from the market failure analysis and UK experience suggests that a conduct of business regime is appropriate (Para 6.5). Instead, they seem to suggest that there is little need for a conduct of business regime for firms conducting wholesale business.

### **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?**

*Many CDWG members believe that the exemptions under article 2(1)(i) and article 2(1)(k) should be replaced by a new exemption covering persons (other than operators of an MTF or of a regulated market) whose main business consists of dealing on own account with professional counterparties in relation to commodities and/or commodity derivatives or other non-financial derivatives contracts covered by MIFID (under points 5, 6, 7, 9 and 10 Section C, Annex I).*

This new exemption would apply to such an entity's activities when dealing on own account in those derivatives contracts with professional counterparties, within the expanded definition

described above. The exemption should not be available to an entity if it seeks to deal with retail investors.

The new exemption would avoid referring to "firms whose main business consists exclusively of dealing on own account". The new exemption should be structured in a way that is clear and less open to misinterpretation.

The CDWG believes that it should be possible to combine the aforementioned exemption with other exemptions, such as article 2(1)(b). As mentioned in our response to question 13, several CDWG firms also believe that an exemption corresponding to the first limb of the Article 2(1)(i) exemption should be maintained (please refer to our response to question 13).

As discussed previously, we are open to the idea that an exemption for own account trading with professionals could be available for the purposes of some of the commodities-related activity of financial institutions, subject to thorough review of the impact of such a change.

*Member states should be required to implement this new exemption into their national law.* There should be a common approach across Europe as to when this exemption is available. Firms covered by the new exemption would be exempt from capital requirements under the CRD.

The CDWG believes that firms that are eligible for the new exemption should be able to elect to be regulated under MIFID instead (i.e. to be able to opt in to regulation), should they wish to benefit from an EU passport. Firms that are eligible for the new exemption and elect to be regulated under MIFID and other MIFID regulated firms whose main business is providing investment services or activities in relation to commodities and/or commodity and exotic other non-financial derivatives should be able to choose to apply the alternative approach to prudential supervision outlined elsewhere in this response to the HMT/FSA Discussion Paper (and the existing CRD exemptions would no longer apply).

Many CDWG firms (UK-regulated firms in particular) are wary of supporting a suggestion that the exemption we propose should cover provision of investment services to clients of the main business, as currently within the scope of exemption (i). These firms are sensitive to the possible reservations of MIFID-regulated financial institution participants in commodity markets in this regard. This group of firms prefers to focus on an exemption only for own account trading with professional counterparties.

A number of CDWG member firms however (continental European firms in particular) suggest that any new exemption for firms whose main business is dealing on own account in commodities and/or commodity and other non-financial derivatives should also cover a firm that provides other investment services, such as investment advice, in relation to commodity and other non-financial derivatives, where those services are provided as an ancillary activity to the firms' main business. These firms are concerned that the absence of such an extended definition could undermine their ability to continue to conduct business without what they see as burdensome and inappropriate authorisation requirements. In particular, they fear that the unclear boundary between providing tailored information and giving investment advice could affect firms' ability to rely on the new exemption. Similarly, some joint venture companies that provide services to their shareholders are concerned about the results of the removal of the exemptions for services provided as an ancillary activities, especially given that article 2(1)(b)

only covers services to a parent undertaking, not to shareholders holding other levels of participation in the joint venture.

*In response to question 15, then, it is clear that a large number of commodity firms would be brought within scope of MIFID were exemption (i) to be fully removed.* The impact of such regulation would seriously jeopardize the attractiveness of European commodity derivatives markets for participants that had previously been exempt from MIFID. This impact would be felt by participants all sizes in these markets. It is worth noting that the participants in these markets that would be least able to adapt to such a new reality would be small and medium-sized commodity firms that play such a key role as liquidity providers in these developing markets. These firms would find it difficult to countenance the administrative and financial challenges inherent in a licensing requirement: in particular the massively elevated capital requirements and the corporate restructuring that would be forced upon them by such regulation. Ultimately, they would have to seriously consider alternative business locations and markets if faced with this level of regulation – undermining European competitiveness and the liquidity of EU markets.

In examining the case for regulation of commodity firms, it is necessary to consider, in the context of the objectives of such regulation, whether it is necessary or desirable to impose a given regulatory regime on this class of firm at all. The overriding characteristic of these markets is that the market participants are wholesale, professional counterparties who understand the risk incurred in the transactions they enter into in this market and are able to manage their own positions accordingly. The CDWG does not believe that authorisation and capital requirements, which look to a combination of retail investor protection, systemic stability and market integrity, are appropriate regulatory tools for the commodity markets.

The removal of 2(1)(k) of MIFID would currently create problems for companies trading in commodities and commodity derivatives who rely on this exemption because of the narrow interpretation that appears to be placed by regulators on the alternative exemption 2(1)(i) where they limit it to non-speculative deals through the use of the term “ancillary”. Similarly, the narrow interpretation that the European Commission has placed on 2(1)(d), limiting it to person who deal on own account who are not “market makers” and do not deal on a “organised, frequent and systematic manner” re-enforces the need for the (k) exemption. The removal of 2(1)(k) could severely restrict the ability of such companies to deal in commodity derivatives as a profit-making activity without authorisation and consequently have a damaging effect on market liquidity.

*We would like to underline that the removal of exemption (k) is strongly opposed by CDWG member firms, who are very concerned at the financial and regulatory implications of such a prospect. Removal of exemption (k) would bring into MIFID group companies from the largest commodity firms in Europe.*

CDWG members believe that regulation under MIFID would come at a prohibitively large financial cost, in particular due to the potential application of Pillar I capital requirements under CRD. Individual CDWG member firms have already run figures on the impact of this scenario. The CDWG would be happy to facilitate sharing of this information with HMT and the FSA on a confidential basis.

The members of the CDWG are working towards publication of research quantifying the impact of application of CRD to them, as a result of regulation under MIFID. CDWG members would be happy to discuss this project with HMT and FSA officials in due course.

**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?**

The exemption in article 2(1)(d) and the own account exemption in article 2(1)(i) are quite limited. The latter exemption is only available where the trading is "ancillary" while the former is only available where the firm is not a "market maker"- a term which may be interpreted more broadly than it is in the UK - or seen to be trading "on a systematic basis", or providing a system to third parties. CDWG member firms do not in general feel they can rely on the (d) exemption. CDWG member firms generally perceive a lack of clarity as to either whether they would qualify as market makers, or if they would be caught by the other exceptions in exemption (d).

The CDWG strongly believes that, if there is support for the principle that own account trading by commodity firms with professional counterparties should be exempted by MIFID, this result might best be achieved by focusing efforts on retention of the (i) and (k) exemptions (or an amended form of the (i) and (k) exemptions). We note that Article 65(3) of MIFID only calls for review of exemptions (i) and (k) applying to commodities business. We fear that foregoing retention of the (i) and (k) exemptions in favour of opening up amendment of exemption (d) – which CDWG firms believe would not suffice to ensure exemption from MIFID – could result in the worst of all worlds (deletion of exemptions and (i) and (k) and an unsatisfactory re-drafting of exemption (d) covering no (or very few) of the commodity firms currently exempted from MIFID).

The deletion of Article 2(k) could bring a wide range of market participants in the wholesale energy sector into MIFID. In particular, they will not always be trading to hedge an identified commercial exposure but in order to take advantage of perceived profitable opportunities. It may be difficult to establish whether they are or are not market makers or providing a relevant system for the purposes of article 2(1)(d).

The deletion of article 2(1)(k) could include a wide range of market participants in the wholesale energy sector. The potential additional cost to such firms of complying with MIFID and the related capital rules is very significant.

In addition, there are likely to be a significant number of firms that rely on the "with or through" exemption, e.g. unlicensed affiliates of regulated firms, where the regulated firm acts as the arranger of transaction. It is unclear whether those firms would fall into the licensing regime if article 2(1)(i) and (k) were abolished – naturally these firms are also concerned at this prospect.

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

*The CDWG believes that client categorisation under the current MIFID rules fails to acknowledge the expertise in commodity markets held by relatively small market participants, and those engaged in commodity derivatives business for the purpose of hedging a position in the physical underlying arising from the production or industrial use of that underlying.*

We therefore propose that the definition of “Professional” should be expanded by:

- Allowing firms to treat undertakings as professional clients where the undertaking is part of a group of undertakings which meets the existing size thresholds on a consolidated basis, thereby allowing for the inclusion of small trading arms of large industrial companies with extensive market experience.
- Including companies with securities listed in Europe or under comparable regimes elsewhere (and their subsidiaries) as professional clients and eligible counterparties, regardless of size.
- In relation to commodity and non-financial derivatives, including undertakings whose main business includes trading in commodities or the underlying subject matter of any such non-financial derivative, or that are producers or professional users of commodities or such underlying subject matter.

Our proposed exemption expands the list of professional investors and eligible counterparties to include undertakings whose main business is trading in commodities or the underlying subject matter of any such instrument or that are producers or professional users of commodities or such underlying subject matter. Because of the nature of their business, these firms should have a developed understanding of the markets in the physical underlying and utilise the derivative markets for the purpose of hedging and ensuring future supply of raw materials. In the event that such firms are not classified as professional, there is a strong risk that market participants will cease to trade with these firms, thereby penalising the smaller businesses that the legislation is intended to protect. This would in turn further reduce liquidity in what are already relatively illiquid markets.

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

The CDWG does not advocate a revision of the MIFID definition of financial instrument.

The CDWG opposes any suggestion that physically deliverable contracts that are currently out of MIFID scope and that include an option (assuming agreement of both parties) of cash settlement should be included within the scope of MIFID financial instruments. These instruments have very different purposes from MIFID financial instruments (involving management of commercial risk, facilitating notification and delivery of the underlying) and we

see little value in opening this issue up. In particular, we note that including these instruments within the scope of MIFID would present commodity firms with an even larger (and more unfair) potential capital requirement should they be made subject to CRD.<sup>2</sup>

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

There is some confusion regarding the treatment of physically settled derivative contracts on emissions allowances. It is not entirely clear that such contracts qualify as financial instruments if they meet the requirements specified in article 38(3) of the MIFID implementing regulation. Such instruments should be treated in the same way as other derivatives on commodities and the other specified underlying subject matter.

**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?**

As commodity firms pose little systemic risk, the CDWG does not consider that a differentiated capital regime would be a proportionate response to these minimal risks. *It advocates mandatory exemptions for firms trading for own account.*

However, to the extent that MIFID applies to commodity firms, *the CDWG supports the “Alternative Approach” to prudential regulation.* We believe the “Alternative Approach”, which removes the need for computing and holding a minimum level of regulatory capital in favour of a requirement to ensure an appropriate level of financial resources together with the need to demonstrate adequate systems and controls, is a more appropriate regulatory framework proportionate to the risks that have been identified in this sector.

Market participants believe that the imposition of an unmodified CRD will drive many firms to make changes in corporate structure, encouraging subsidiarisation of otherwise integrated business lines purely in order to comply with CRD requirements. The proposed capital requirements may force smaller firms out of the market and exclude new participants in markets which already suffer from limited liquidity. The continuing existence of lighter touch regimes outside of the EEA provides larger firms with an incentive to relocate their activities to the detriment of EEA nations.

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<sup>2</sup> Please note that a query recently came to us from the CESR-CEBS commodities working group, asking ISDA if ISDA commodities documentation includes options for cash settlement. Our reply was as follows:

*“Cash-settled or physically-settled commodity derivatives, including options, can be entered into under an ISDA Master Agreement. However, details of specific transaction types, including agreement between the two counterparties as to the method of settlement, will be governed by reference to a standard set of definitions, in this case the 2005 ISDA Commodity Definitions, which would be referred to in the relevant Confirmations covering the transactions. The Master Agreement provides the contractual framework for transacting between the two counterparties for a range of derivative instruments, as well as including set-off and close-out netting provisions.*

*The ISDA Master Agreement framework facilitates trading in spot and forward commodities (or outright purchases and sales of certain physical commodities), commodity options, caps, floors, collars, swaptions and swaps. Options are usually cash-settled, but can be physically settled depending on the motivations or needs of the counterparties. Options provide protection against adverse price changing the underlying commodity with the seller compensating the buyer for the difference between the price of such commodity and the strike price. The buyer of the option may wish however to take delivery of a commodity such as coal, in which case it would enter into a physically-settled option with the exact specification of coal agreed at the time of trading.”*

Members of the CFRC working group are considering conducting a Pillar 1 Impact Study and we would hope to share with CESR/CEBS, the European Commission, HMT and the FSA the output from any such initiative later in the year.

A disproportionate capital regime for commodity firms will have a disastrous effect on commodities markets.

**Q25 - 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?**

The CDWG addressed some of the flaws in current CRD rules for the purposes of commodities business in its response to questions 4 (a), (b) and (c) of the CESR/CEBS Call for Evidence. We refer you to this text, in annex to this paper.

**Q26 – What are your views on the Pillar 2 type approach put forward by a section of industry?**

We need to be careful in labelling the “Alternative Approach” a Pillar 2 type approach. Although there are similarities between the two, and in fact we apply the same basic fundamental concept underlying Pillar 2 to the Alternative Approach, that a well managed firm must be aware of its own financial resources and measure them against the risk appetite of the business, there are however significant differences. The “Alternative Approach” also draws on CRD Pillar 3.

The starting point for Pillar 2 is Pillar 1, and an Internal Capital Adequacy Assessment Plan (ICAAP) and the Pillar 2 framework concludes with the possibility of additional minimum regulatory capital requirements following the Supervisory Review and Evaluation Process (SREP).

The Alternative Approach is based on “adequate financial resources” as regulatory capital is not seen as an appropriate mitigant to the risks run by commodities firms. What constitutes adequate financial resources will vary from firm to firm as a function of the nature and scale of the business, together with the risk appetite and risk management systems of the firm. We do not therefore propose specific limits on financial resources that would apply to a firm adopting the Alternative Approach. Instead the individual firm must justify the composition and extent of the financial resources that it believes to be adequate, potentially, but not necessarily, with reference to other regulations.

The CDWG advocates that MiFID commodity firms should be able opt to apply the Alternative Approach.

**Q27 – 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?**

**Q28 - Do you think this approach is suitable for a wider range of firms? If not, why and can you provide evidence to support this?**

As discussed above, the CDWG supports an exemption for those firms that do not deal with retail investors.

**Q29 – Do you have any evidence of problems in relation to transparency in the derivatives market?**

We are not aware of any evidence to suggest that there are any transparency-related problems in the commodity derivatives market.

The June 2007 CESR report on non-equities transparency also opined that there is no evidence of “transparency-related concerns” in inter alia, commodity derivatives markets.<sup>3</sup>

**Q30 – Do you agree that commodity derivatives should be removed from the scope of the MIFID transaction reporting regime? Why?**

The CDWG believes that an independent transaction reporting regime for the purpose of exchange-traded commodity derivatives adds no value. Regulators can get the information they receive from the exchanges/MTFs.

We do not believe that this issue is a priority, however. We believe that the most important issues in the current EU review of regulation of commodity derivatives are the status of the current MIFID exemptions for commodities business and addressing the potentially very damaging impact of a disproportionate capital regime for commodity firms.

**Q31 – Do you see benefit in position reporting? Why?**

We are aware that there are some views from within industry that position reporting is a more relevant discipline for the purposes of trading of commodity derivatives than transaction reporting. The CDWG has not discussed this issue at length and would prefer to reserve its position on this matter at this point.

Again, we see the issues around the MIFID exemptions and capital as our key concerns in the context of the MIFID Commodities review.

We will be addressing issues around transaction reporting for commodity derivatives in our response to the CESR-ERGEG Call for Evidence on this issue.

**Q32 – 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?**

The review of the Market Abuse Directive would seem the obvious workstream through which to look at the regulation of commodity firms for the purpose of MAD.

The CDWG is aware of the concerns of banks and investment firms, as expressed by LIBA, concerning what banks and investment firms see as a “difference in regulatory grip” on the behaviour of commodity firms in the context of market integrity. It is our understanding that banks believe that this amounts to an unfair competitive advantage for some unregulated market participants over banks (and indeed commodity firms who are publicly quoted companies in Western Europe and therefore subject to the strong imperative to preserve their reputation).

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<sup>3</sup> Paragraph 28, CESR Response to the Commission on non-equities transparency, June 2007.

Banks and investment firms would like to ensure that regulators have the powers to investigate when aberrant behaviour is apparent and enforce proper market standards. They propose that a useful, practical solution in this regard would be to apply the MAD regime to commodity MTFs as Prescribed Markets – thus, in their view, achieving this end without extensive re-writing of the whole MAD regime. The scope in this regard would be behaviour ‘in relation to’ MTFs, not narrowly trading on them, but should not affect directly or indirectly the existing insider dealing and insider information provisions.

LIBA has expressed the view to the CDWG that it could have more confidence in the level of regulation around commodity firms for the purpose of MIFID and CRD if the relative standard of regulation for market integrity in the commodities area was addressed in this way.

LIBA is cogniscent of the scope for unintended consequences in such an exercise (as in any potential change in regulation) but would welcome a commitment to the principle underlying this proposal, before any full consideration is undertaken.

The CDWG is currently considering the LIBA proposal in this regard, and exploring the scope for a common position with LIBA on this issue.

## Annex 1

### **ISDA**

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Mr Peter Smith

Financial Institutions F2

Internal Markt DG

European Commission

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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),<sup>4</sup> to set out clearly the reasons why it decided, at the outset, that

<sup>4</sup> Under article 65(3) MiFID and article 45d(2) of the Capital Adequacy Directive (CAD), as recast by the CRD.

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.<sup>5</sup> 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.

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.<sup>6</sup>

### **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.

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

<sup>6</sup> Under article 65(3) MiFID

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.

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 subsidarise 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 Sebton, Anthony Belchambers or Martin Spanier at [esebton@isda.org](mailto:esebton@isda.org); [belchambersa@foa.co.uk](mailto:belchambersa@foa.co.uk); or [martin.spanier@syneco.net](mailto: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**

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Amalgamated Metals Trading  
Becker Buttner Held  
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Clifford Chance  
ConEnergy  
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