

**Call for Evidence - Review of Commodity and Exotic Derivatives and Related Business as
Required by MIFID and Recast CAD**

ISDA-FOA-EFET Response

This response to the Commission's Call for Evidence in relation to the Commission's review of commodity and other non-financial derivatives and related business required by the Markets in Financial Instruments Directive (MIFID) and the recast Capital Adequacy Directive (CAD) represents the views of the International Swaps and Derivatives Association (ISDA), the Futures and Options Association (FOA), and the European Federation of Energy Traders (EFET). These organizations have been cooperating as part of the 'Commodity Derivatives Working Group' (CDWG), with the aim of drafting this joint response.

Where we use the term 'CDWG' in this submission, we are referring to the view jointly held by each of these associations regarding the Call for Evidence.

The CDWG assumed that sections of our response might be read by individual officials (and these officials may not read the entire paper). For this reason, some answers may seem 'exhaustive', and may repeat comments already made in the submission.

ISDA represents participants in the privately negotiated derivatives industry, and is the largest global financial trade association, by number of member firms. Chartered in 1985, ISDA today has over 780 member institutions from 55 countries on six continents, including 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 (including commodity firms) 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, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector.

Established in 1999, **EFET** is an industry association representing over 80 trading companies operating in 20 countries. The EFET mission involves improving conditions for energy trading in Europe and fostering the development of an open, liquid and transparent European wholesale energy market.

Executive Summary

The CDWG believes that it is vital that the European Commission avoids inappropriate regulation of commodity derivatives and commodities trading, if Europe is to develop a deep, liquid, competitive and efficient commodities trading market.

The CDWG welcomes the European Commission's open mind as to the different approaches that could be taken to ensuring appropriate oversight of the market in commodities (and

development of these markets). The CDWG appreciates the wide variety of ideas and approaches raised in the December 2006 Call for Evidence on Commodities. The CDWG is also aware that this Call for Evidence is a key part of a review which is being undertaken by the European Commission primarily as a result of the mandate under MIFID and the CRD. We understand that without this mandate, the EC would not seek to review regulation in this area at this time.

In response to the questions put to respondents in the Call for Evidence, the CDWG will outline its view of how trading of commodity derivatives and commodities should be regulated. In particular, the CDWG proposes that, concerning regulation of commodity firms:

- MIFID should exempt own account dealing between professionals – as regulation of these firms under MIFID is (a) not justified on investor protection or systemic risk grounds; (b) would have significant negative effects on market liquidity, on the price of commodities, and on the competitiveness of Europe’s commodities market and commodity firms – at a time when all of these issues are at the forefront of the EU’s policy agenda; and (c) would not necessarily deliver all of the benefits that the Commission aspires to in its review of MIFID – and, we believe, not at a proportionate cost to the market.
- This exemption should be applied in a binding way in every Member State, with no possibility for Member States to adopt ‘super-equivalent’ regimes (i.e. no ‘gold-plating’) – thus ensuring a true ‘single market’ approach.
- For commodity firms’ activities that are not covered by this exemption, a special and risk-adjusted prudential supervision regime should be applied, based on appropriately enhanced internal risk management systems and disclosure. Commodity firms’ activities are simply not comparable to those of financial institutions, in terms of systemic risk incurred. In fact, minimum capital requirements under the CRD would not, we feel significantly increase the stability of the European financial system; rather, it could force smaller firms out of the market and exclude new participants in markets which already suffer from limited liquidity. Another unintended consequence of this approach could be to provide some larger firms with an incentive to relocate their activities to take advantage of lighter touch regimes outside the EEA, to the detriment of EEA markets. A proportionate ‘specialist’ MIFID regime should also apply to these firms’ activities, based on a revised version of the ECPs regime (see our response to Questions 16, 17 and 18).
- We do not believe that any financial services based authorisation or licensing requirements should be proposed for firms conducting physical wholesale trading and spot business between professionals.
- We are open to exploring, with the Commission, ways of improving any gaps in market conduct rules, e.g. as regards trading of commodity derivatives on MTFs (see the relevant sections of our submission).

Of course, the CDWG would like to ensure that any steps towards new regulation in the commodity derivatives and commodities trading markets is justified by rigorous cost-benefit analysis and impact assessment, as well as broad consultation. In addition, should any new regulation in these markets be deemed necessary, we feel that it would be appropriate, and in keeping with European Commission's support for the principles of better regulation, for examination to be given to the viability of alternative regulatory tools, such as industry self-regulation, before any 'hard' legislation is considered.

Question 1. Do you believe that the current EU legislative framework gives rise to problems in the functioning of the commodity and exotic derivatives markets?

If yes, please indicate the nature of the problems.

It is not easy, as yet, to evaluate the implementation of MIFID, as many Member States have yet to implement. While some countries, e.g. Germany, have implemented MIFID using a 'copy-out' approach, in particular as regards the relevant definitions of and exemptions for commodity derivatives, we believe that a number of countries may take advantage of the scope for 'super-equivalent' implementation allowed by MIFID (e.g. the possibility of extending the definition of commodity derivatives to other kinds of forward/future transactions in respect of commodity derivatives business).

The absence of a fully harmonised EU legislative framework in respect of commodity and exotic derivatives results in a patchwork of different regimes in each member state, making it more difficult for commodity firms to operate efficiently on a cross-border basis throughout the EU. We believe super-equivalent approaches are detrimental to the European single market in commodity and exotic derivatives.

This observation does not necessarily imply that introducing full regulation, as set out in the CRD and MIFID as currently drafted, on a harmonised basis would be the appropriate solution for firms trading in commodity and exotic derivatives. We believe that any extension of such regulation should be made only after and on the basis of a thorough review which examines the case for regulation of commodity firms including analysis of the costs of extending authorisation in this way against the benefits that doing so would bring – in line with the European Commission's adherence to better regulation policies.

It is worth noting that, currently, a number of EU Member States and non-EU jurisdictions operate regimes which do not seek (directly) to regulate participants in commodity and exotic derivatives markets at all.

We also draw the European Commission's attention to the fact that wholesale, commodity and exotic markets are already subject to legislation other than MIFID¹. The CDWG believes that

¹ For example, the gas, power and emissions markets are governed by specific regulations: Directive 2003/54/EC governing electricity, Directive 2003/55/EC for gas and Directive 2003/87/EC governing emission trading, as well as Regulations 1228/2003 (electricity), 1775/2005 (gas) and the Greenhouse Gas Emissions Trading Scheme Regulation (Statutory Instrument 2005 no.925)

distortions in these markets should be dealt with through harmonized implementation and supervision of this legislation rather than through new financial legislation.

Lastly, we believe that it is important that the EU legislative framework define the right borderline between financial market regulation and regulation of physical markets e.g. oil, gas, power and emissions markets, particularly as regards the scope of the regulated area, and the powers of regulators.

Question 2. If there are significant problems, do you believe the three broad approaches outlined above are an appropriate starting point for a formulation of more detailed policy alternatives or is there another option that should be considered?

The CDWG would like to make the following general comments about the three approaches outlined in the Call for Evidence:

1. ***Status Quo options (maintain MIFID exemptions and allow CAD exemption to expire)***
– The CDWG has major concerns regarding this option. In particular, maintaining the exemptions as they are, while failing to address the ‘patchwork’ of different implementing approaches (e.g. a number of Member States have not implemented these exemptions, and it is by no means clear if and how they will do so), will mean that it remains more difficult for specialised commodity firms engaging in commodity trading to act on a cross-border basis.

In addition, the CDWG feels that prudential regulation of commodity firms needs to be proportionate to the systemic financial risk presented by these firms which are significantly less than those posed by any financial institution. In this context, we note that the ‘status quo’ option would mean that the current exemptions in respect of firms carrying out commodities and commodity derivatives business in Article 45 and 48 of CAD would expire as of 31 December 2010 – thus subjecting regulated commodity trading firms to minimum capital requirements under the CAD. This would, we feel, impede the liquidity and competitive development of the market in commodity and commodity derivatives trading. In addition, we question whether applying capital requirements to commodity firms would, in our view, have a significant positive effect on financial stability in Europe.

The CDWG stresses, however, that although it does not support the application of minimum capital requirements under the CRD, it believes that commodity firms should still have sufficient resources to support any risk-taking activities.

2. ***Extension of the MIFID and CAD regime (abolition of MIFID exemptions, and allowing CAD exemptions to expire)*** – The CDWG opposes this option. Application of the full MIFID is not appropriate in a predominantly wholesale market, and application of full capital requirements would not be justified, given the lack of financial systemic risk presented by commodity trading firms. Extending the MIFID and CAD regimes would create disproportionate and excessively burdensome rules on commodity firms.

We also question whether applying capital requirements to commodity firms would, in our view, have a significant positive effect on financial stability in Europe.

We believe the net impact of option 2 would be to reduce liquidity and competition in the market, by inhibiting many small (liquidity-providing) firms from entering the market, and forcing many other commodity firms to consider establishing themselves outside the EEA).

- 3 ***Creation of specialised commodity derivatives regime*** – The CDWG has concerns that any ‘specialist’ regime the European Commission might consider applying to commodity firms could still impose inappropriate and disproportionate requirements e.g. organizational requirements, investor protection rules, client classification rules and capital requirements that would stifle the development of the market in commodities and commodity derivatives, by inhibiting firms from entering the market (or encouraging them to move to third countries), and reducing liquidity in these markets. We do not therefore support the creation of such a regime. If such a regime is proposed by the Commission, however, the CDWG would encourage them to consider implementing a risk-adjusted “eligible counterparty” regime for appropriate specialist commodity dealers the details of which are further described in our answer to question 17 and 18 hereunder.

The CDWG would like to propose an alternative to the ‘specialist’ regime, which might be viewed as a variation on the "status quo" option described above. This alternative would maintain an exemption for **own account trading between professionals**, with Member States required to implement this exemption on a non-discretionary basis – thus preventing ‘super-equivalency’. This would ensure harmonisation at member state level as to the boundary of regulation for these markets. Further details of this option are set out later in this submission. For firms engaging in activities (e.g. investment advice) that would be within MIFID scope, we would propose an ‘appropriate’, specialist regime, along the lines of that described in our answers to questions 17 and 18.

Of course, adoption of such a course should only be pursued following thorough consideration of its impact, as well as the costs and benefits that would accrue in the European commodity trading market. However we believe that these markets can benefit from this approach in terms of liquidity, price formation and competition.

Identification of professional investors for the purposes of this exemption would be key in this instance, and ISDA, the FOA and EFET believe that this issue should be approached carefully, with a view to ensuring wide participation in the market, on reasonable terms.

Question 3. Do you have a preference for one of the approaches outlined above?

As mentioned, none of the three approaches mentioned in the European Commission’s Call for Evidence are completely satisfactory, from the point of view of the CDWG - hence the reason for the inclusion of the alternative we propose, above (maintaining an exemption from MIFID

for own account trading between professionals, with no scope for super-equivalence on this point in the Member States)

Nevertheless, despite the European Commission only having listed the 3 options explored above as ‘basic choices’, we welcome the European Commission’s stated ‘open mind’ on the most appropriate regulatory framework for trading of commodities, and look forward to further dialogue on this issue.

Question 4. Do you agree the Report should be drafted in light of the above principles/objectives?

In our view, *market integrity* and *investor protection*, though linked, are separate objectives. In the context of wholesale commodity derivative markets, *investor protection* rules designed to protect customers and counterparties from malpractice would be inappropriate, where all parties are wholesale, professional counterparties. *Market integrity* is a separate issue of importance to all market participants and end users, irrespective of the nature of the market.

We fully support the *market integration* principle, underlining that a harmonized approach allowing commodity firms to take advantage of a true single market is key. We also endorse the Commission’s comment in this context on the importance of a well-functioning and liquid market in commodity derivatives and the goal of achieving a deep and fully-integrated market in the underlying commodity sector itself. The promotion of liquidity and the establishment of open rights of access and regulatory proportionality are all critical to achieving that objective.

The CDWG also agrees with the principle/objective of *enhancing the global competitiveness of EU firms*. Of course, a competitive, efficiently functioning market in commodity derivatives will contribute to the integration of the physical market – and this in turn will have beneficial effects on the cost of e.g. energy for EU firms. The CDWG, however, underlines that the market in commodity derivatives must not be established in such a way as to lead commodity firms to conclude that they must, by virtue of extensive regulation and associated costs, establish their businesses in countries outside of the EU – thus undermining integration, participation and market liquidity. It is also important to note that application of regulation (e.g. which is disproportionate to that applied to commodity trading firms based outside the EU) could have a negative effect (rather than the aspired-to positive effect) on *global competitiveness of EU firms* trading in commodity derivatives. As the EC is seeking to improve the *global competitiveness of EU firms*, it is important to ensure that any new legislation (or changes to legislation) introduced delivers on the aims to which it aspires

The CDWG agrees that a *level playing field* is important – but does not believe that imposing full MIFID and CAD rules on commodity firms’ derivatives trading will achieve a level playing field. Rather, this would place commodity firms at an unfair disadvantage in the market. The CDWG believes that a ‘level playing field’ should not mean that commodity firms are regulated in exactly the same way as investment firms – and recalls that in several financial policy areas, different types of firm carrying out similar activities/services are regulated in varying ways. Having said that, the CDWG supports consideration of how market integrity rules for

commodity firms could be improved, with a view to reassuring all participants in the market that fair and even standards of market integrity apply.

The CDWG also believe that commodity firms should be able to take advantage of a *level playing field* in terms of level of regulation in each Member State across the EU, with equivalent rules implemented and applied in every EU Member State. In other words, goldplating should be avoided in the commodity derivatives market if this market is to thrive. Only through creation of a true single market, with firms able to operate freely across borders, will these markets become deep and liquid enough to thrive – with the attendant benefits this implies for commodity firms and the European economy as a whole. The current patchwork of regulation in different EU markets has a negative effect in a number of areas, including pricing and competition.

We also note that the comments of the EU Commission on *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 problems, completely independent from financial regulation and the implementation of MIFID which undermine the development of a level playing field for these physical commodities. The CDWG believes that these problems will not be successfully resolved through an extensive MIFID-licensing regime. Additionally, the activities of the market participants vary too much for a “one size fits all” MIFID-approach, because such an approach would actually create inequalities between markets participants.

In addressing the *level playing field* in relation to physical markets, we would prefer an emphasis on energy market regulations and energy market regulators.

As mentioned later on in this submission, we would be open to further dialogue with the Commission concerning market abuse rules in the commodity derivatives sector. Any action in this context should be subject to impact assessment, cost-benefit analysis and broad consultation, however.

The CDWG believes that *security of supply* is a valid and important objective/principle, but does not agree that financial regulation is the appropriate tool to deliver this. This objective is directly relevant to the non-storable commodity markets such as the power market where there is a requirement to balance demand with available supply at each point in time. Ensuring security of supply in this context has always been the preserve of physical regulators such as OFGEM who have the skills and resources appropriate to this form of regulation. The objective to ensure security of supply must rightly remain with these physical regulators. In this context, the CDWG strongly believes that there should be a clear unambiguous distinction drawn between the derivatives sector and the underlying physical sector – and that the physical sector should *not* be the subject of financial regulation.

Question 5. Are there any principles/objectives we have not listed which you consider important?

We believe that the EU's efforts towards "energy liberalization" will be impacted by the outcome of this review, and as such we would like to ensure that the European Commission considers this impact in the course of its review.

As highlighted in studies performed over the last two years by DG TREN and DG Competition and published by the Commission on 10 January this year, these markets are at an important stage in their development.

An increasing number of European consumers enjoy the freedom to choose their supplier thanks to the first and second packages of EU electricity and gas internal market legislation. However, the benefits of this increased choice will not be realized without liquid, efficient and integrated wholesale energy markets, based on free competition. New entry into retail, import and generation markets will only take place on a significant scale if potential market participants gain confidence in a liquid and transparent wholesale, traded tier. To become successful entrants they require a reasonably deep wholesale market, in which to source their electricity, gas and other commodities and manage their output, basis, and price risks.

In this regard, the CDWG believes that many problems in energy markets, such as lack of competition, domination by incumbents, and general opacity common to many markets, could be effectively tackled by effective implementation of the second energy liberalization package². However these problems cannot be addressed by financial regulation – rather, we believe that energy regulators should be allowed to sort these issues out.

In this still fragile stage of energy liberalization, many players fear the financial regulation of commodity derivative transactions, especially the imposition of regulatory capital requirements, may erect a further barrier to entry to the fragile continental European power and gas wholesale markets. In this context, we see regulation of transmission access and the provision of related monopolistic services as the more appropriate regulatory framework for the underlying physical markets.

Question 6. Is there a hierarchy between these objectives/principles? If yes, please provide a ranking.

The CDWG does not see any need to insist on the relative importance of any one of these objectives/principles above the others.

Question 7. Do you think that the close relationship between the underlying and derivatives markets warrants an investigation of the underlying markets as part of the Report?

² Problems we refer to here include a lack of development of competition even in key markets for certain commodities, such as the German gas market, slow (or no) progress in market opening in the 'new' EU Member States and Switzerland, and domination by incumbents in many countries. Other technical problems also continue to deter new entrants, such as the lack of cross-border cooperation between TSOs, cooperation and integration problems in intra-day and balancing markets, and the complexity, cost and lack of transparency in third party access regimes in gas markets.

The intersection of forward supply and demand sets the forward price. In this sense, the equilibrium reached in the physical market at future points in time forms the backbone of the forward price curve, and underpins the derivatives market. It is understandable therefore that the Commission should wish to understand the underlying commodity markets. It does not follow however that the physical market should become a focus of the Commodity Review. There is, in our opinion, no reasonable rationale for the intervention of financial regulators in the physical sphere.

The physical market is a fundamental driver of the derivatives market: participants engaged in the physical trading of commodities routinely make use of a number of hedging techniques, including derivatives, to guarantee the price at which they will sell commodities extracted or manufactured in the future. Conversely, users of commodities employ derivatives to cap the price at which they will purchase commodities. Many players are at the same time producers and users of commodities: a power producer for instance may rely on supplies of coal, oil or gas. Physical market players may not only hedge price risk, they may also mitigate a variety of commercial risks and costs inherent in transporting commodities from one point to another e.g. interest rate and exchange rate risk and the use of freight futures.

We understand that the practical effect of MIFID is to exclude all such hedging activities. These are in principle similar to the transactions a corporate's treasury department would engage in to hedge risk inherent in the corporate's core business.

As already explained, we believe that a wider set of commodity firms' own account trading activity should be exempted from MIFID.

One further point for consideration here is the relationship between the spot price of a commodity and its forward price, which is considerably more complex than the relationship between the spot price and the forward price of a security.

- (i) Commodity prices are principally driven by the intersection of supply and demand; demand is highly variable, influenced by time of year or specific events, such as the weather conditions. Supply itself can be influenced by catastrophic events, storage constraints or the perishability of certain commodities.
- (ii) Forward commodity prices take into account the cost of storage and convenience yield. In financial markets, current and future prices are linked by a simple relationship involving only the time value of money and the future cash flows expected to be received on the security. In storable commodity markets, the cost of storage and convenience yield (i.e. the perceived benefit of holding the commodity), otherwise known as "cost and carry", influence the relationship between the spot price and the forward price. In the non-storable commodity markets, such as the power market, carrying the commodity forward for use at a later point in time is not an option, which in turn creates a disconnect between spot prices and forward prices. When the spot price at a future time is greater than the forward price for that maturity, the market is said to be in "backwardation". This situation is normally found where supply is perceived to be tight in the short run. The opposite relationship between spot and forward prices is known as a "contango".

- (iii) The volatility of forward commodity prices tends, all else being equal, to decrease the further forward their maturities. This is because the arrival of news influences short term forward prices. At the longer term end of the spectrum, production, rather than price, is expected to adjust. Short term volatilities can be very high.

Although there is a relationship between spot and forward prices, the nature of this relationship can vary, particularly for non-storable commodities.

It follows from the above that from a market risk management perspective, forward positions are imperfectly correlated with spot positions. Offsetting spot and forward positions is only possible over short periods of time.

Question 8. Which features of EU financial markets regulation, if any, do you think could be potentially of interest or application in the commodity wholesale trading?

As mentioned later in this paper, we are open to discussion of how market integrity rules might be revisited e.g. trading on commodity MTFs. Any move in this direction should be justified by impact assessment, cost-benefit analysis and broad consultation, however.

In general, however, we do not consider that financial markets regulation is the appropriate method or model by which to consider regulating the operation of physical commodity markets.

We also wish to remind all of the relevant services of the Commission, that physical trading in the more liquid and sophisticated wholesale energy markets in north-western Europe does not require a license (in contrast to the well recognized justification in those jurisdictions for a retail supply license.) Member State ministries and energy regulators in the original EU-15 were quite comfortable with this state of affairs. The experience among power and gas traders is that the criteria for qualifying to be a nominating party and balance responsible entity, according to TSO (Transmission System Operators) rules for access to the transmission system, are so stringent, that in practice further administrative controls on physical dealing would be superfluous. If we add to these criteria, in the case of electricity markets, the typical rules and market supervisory practices of power exchanges, and the competences of some energy sector regulators and most competition authorities to launch national investigations into any suspected market manipulation, then the panoply of existing controls applying to the physical energy markets seems adequate.

Question 9. Do you consider that the rationales for maintaining or removing the exemptions under MIFID Article 2(1)(i) and 2(1)(k) are essentially the same for both exemptions, i.e. related to issues of capital adequacy? If not, why not?

We do not consider that the rationales for maintaining or removing the exemptions under MIFID Article 2(1)(i) and 2(1)(k) are related solely to issues of capital adequacy.

In examining the case for regulation of commodity firms, the Commission should ensure that its review re-examines the objectives that the imposition of authorisation requirements aim to achieve and the question of whether it is necessary or desirable to impose such a regime on this

class of firms at all. This assessment is essential because the overriding characteristic of these markets is that (like the markets in underlying commodities) 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 in this regard. Authorisation requirements which aim to mitigate risks to regulatory objectives, particularly in the context of retail investor protection, systemic stability and market integrity, may not be an appropriate means of doing so in the context of commodity markets – and, we believe, are not appropriate for own account trading between professional counterparties.

Full removal of the exemptions under Articles 2.1(i) and 2.1(k) and the consequent compliance requirements, particularly a minimum capital CAD requirement would likely impact the appetite of certain specialist commodity firms to remain situated within Europe. We also believe that imposition of licensing requirements under MIFID would inhibit new entrants, have a consequent negative effect on competition within these markets, and would impose a disproportionate burden on these firms, undermining the *global competitiveness* aspiration declared by the Commission in the Call for Evidence.

The CDWG believes that the best result, for the purpose of establishing deeper, more efficient and liquid markets, would be to maintain a mandatory exemption for own account trading between professionals. In this respect, we suggest inclusion of new wording in Article 2(1) of the MIFID Level 1 Directive, replacing exemptions (i) and (k), to the effect that persons (other than operators of an MTF or of a regulated market) whose main business consists exclusively of dealing on own account in relation to commodities and commodity derivatives or derivatives contracts (as set out in points 5, 6, 7, 9 and 10 of Annex 1, Section C), between *professionals*, should be exempted.

This would require agreement on a clear definition of ‘professionals’. The CDWG would be happy to explore, in collaboration with the European Commission, the most appropriate wording for this definition going forward.

Question 10. Do you consider that the exemptions under MIFID Article 2(1)(i) and 2(1)(k) and under Article 48 of the recast CAD create a competitive distortion which could be of significant policy concern? If yes, what would be the most appropriate way of mitigating the distortion?

Question 12. Do you consider it appropriate that Member States regulate the entities excluded from the scope of the MIFID and recast CAD a) pending the review of those exemptions; b) if the exemptions are maintained after the review?

Questions 10 and 12 are closely linked. We offer a combined response below.

Article 48 of the recast CAD institutes a temporary exemption, intended to provide the Commission with the time necessary to define an appropriate regime for the prudential supervision of specialist commodity firms.

National regulators, in their transposition of the CRD, have interpreted Article 48 in a variety of ways. Some have implemented the exemption fully: a German MIFID scope commodity firm

benefits from the capital exemption provided at Article 48. Other regulators have chosen to maintain the regulatory frameworks pre-dating the CAD pending the conclusion of the review by the Commission: commodity firms regulated in the UK continue to be subject to prudential requirements under the OMP, EMP or investment firm regimes.

Whereas a majority of commodity firms support a straight implementation of both the MIFID and the CAD exemptions, some participants view the continuation of pre-existing regulation as a pragmatic response on the part of the regulators.

It is true that only the full implementation of the exemptions would deliver a level playing field for commodity firms in the interim period between the adoption of the CRD and the conclusion of the review. The divergent interpretations of Article 48 adopted by the regulators, on the contrary, contribute to maintaining competitive distortions in the EU.

After the review, whichever prudential regime is agreed upon by the European institutions should be implemented consistently across the EU in line with Commission policy. Gold-plating by individual regulators would only serve to hinder the development of a common EU wide commodity derivatives market, and should be avoided as much as possible.

The CDWG reiterates its belief that whichever licensing/conduct of business regime is agreed upon by the European institutions should also be implemented consistently across the EU. If the Commission concludes that the exemptions (or a variation on them e.g. an exemption for own account trading between professionals) should be maintained, national regulations should be amended to incorporate these exemptions, and to prevent Member States from adopting differing national approaches.

The CDWG has a strong preference for Member States to apply the current (temporary) exemptions during the review period and to encourage competent authorities to waive existing capital rules to the extent that they give rise to the type of competitive distortion for commodity firms described above.

Furthermore, we note, with concern, that the “expiry date” (End-2010) of the exemptions at *Article 45* and *Article 48* of the CAD will probably be passed before any new regulatory arrangements have been agreed at EU level.

The CDWG also believes that the investor protection issues that MIFID and CAD are supposed to deal with do not exist at present, since this business is largely a professional market with no direct retail involvement. However the exemption we propose only applies to own account trading between professionals – this exemption would not apply to dealings with retail investors, should this side of the market develop further in the coming years.

On the prudential side, commodity firms do not pose at all the same level of systemic risk as financial institutions in the financial markets and should therefore attract a differentiated regulatory approach (see response to question 15).

Question 11. If there are competitive distortions between persons active in the commodity derivative space and those distortions would be removed, would there still remain a

significant distortion between commodity derivatives trading and spot trading? If yes, what would be the most appropriate way of mitigating the distortion?

In many ways this question is too vague and broad to be addressed directly. There currently exist geographical and sectoral differences in the regulation of players in the commodity derivative markets. However it is our view that a differentiated prudential treatment of specialist commodity dealers is justified. Our motivation and proposals are detailed in the response to questions 13 to 15 of the Call for Evidence.

It is unclear to us which distortions the Commission is alluding to between commodity derivatives and spot trading. Spot trading is physical and prompt in nature and therefore part of the core business of a commodity firm. It is not a financial activity, and therefore quite logically falls outside the scope of MIFID, and is not a matter for financial regulators. The CDWG has concerns about the use of the word 'distortion' here suggesting, as it does, that differences in regulatory treatment between spot and financial activity are, in themselves, negative. This is a bold and unjustified assertion which the lack of evidence or analysis make inappropriate to put as a statement of fact until proven. The spot and derivatives markets are treated differently for the simple reasons that the intentions of traders in each market, and risks in each market, are very different, and they do not compete with each other.

From a risk management perspective, some firms manage spot and derivative exposures jointly, particularly in the storable commodity markets. It should be noted however that trading on the spot markets may represent only a fraction of trading on the derivatives markets. Furthermore, as already mentioned in relation to question 7, correlation between forward price moves and spot price moves is far from perfect. Spot hedging of derivative positions is therefore limited. This being said, it is our view that firms should be given discretion by the regulators to define the scope of the business subject to prudential oversight so that it is consistent with their risk management model. A firm should have the option to include within the scope of CAD regulation products beyond those regulated under MIFID, provided it can demonstrate that these products are risk managed jointly with MIFID financial instruments. It does not follow that spot or forward trading should become regulated under MIFID.

We would also add that not all entities dealing in commodity derivatives are competing with each other. Producers, retail suppliers or consumers using derivatives (mainly to hedge their own commodity positions) have very different priorities to entities that predominantly trade in derivatives without an asset base.

Question 13. To what extent do you consider that the reasons for subjecting investment firms to prudential regulation hold equally for entities providing investment services and, in particular, the service of dealing on own account, exclusively in relation to commodity or exotic derivatives? Do you think that these reasons are (or are not) valid for all or only for some of these entities?

Firstly, it is worth emphasising that dealing on own account is not a service, but an activity that firms undertake. This is key and important distinction under MIFID.

Secondly, we wish to draw a fundamental distinction here between specialist commodity firms and financial institutions. A specialist commodity firm is (i) a commodity firm which has developed a derivatives trading activity, either on the main balance sheet or as a subsidiary; (ii) a trading outfit providing investment services solely in relation to commodities and commodity derivatives. Neither of these categories of firms is covered by the ISD.

We consider that specialist commodity firms do not pose the same risk to the financial system (which we will refer to in the following as “financial systemic risk”) as financial institutions and should therefore receive a differentiated prudential treatment.

The Commission has made clear in MIFID Recital (25) that “the scope of prudential regulation should be limited to those entities which represent a source of counterparty risk to other market participants”. Specialist commodity firms do not pose the same level of counterparty risk to financial institutions as financial institutions themselves.

There is little doubt that commodity firms, particularly those active in concentrated markets (e.g. the power market in the EU) are systemic in the sense that their failure could disrupt the immediate supply of a commodity and/or alter its price for a short period of time. This could be termed “physical” systemic risk, by contrast with financial systemic risk.

In as much as financial institutions are active in the same markets as commodity firms, those financial institutions are potentially exposed to two main forms of risk in their dealings with commodity firms:

- (i) default risk, through direct credit exposure;
- (ii) market risk, through exposure to commodity prices potentially affected by physical systemic risk.
- (iii) Default risk can result from broadly three types of credit exposure:
 - equity ownership;
 - loans;
 - counterparty credit exposure.

The first two are found in banks’ balance sheets with respect to all corporates and not unique to commodity firms: e.g. it has never been suggested that IBM should be subject to the CAD because banks are lending to it or owning IBM shares. Therefore these two categories of exposure should not be considered in assessing whether commodity firms warrant prudential supervision.

The third category of credit exposure may be more prevalent in the case of commodity firms, if they hedge their core exposure to physical commodity risk more actively than the treasury departments of other large corporates, their exposure to FX or interest rate risk. However, as stated already it is not intended that pure hedging activity should be subject to regulation in MIFID (we refer here to the ‘commercial purpose’ test). The counterparty credit exposure that is

the focus of the prudential framework currently under consideration stems from pure “speculative” trading. Financial systemic risk will arise with respect to this business only if it is sufficiently large as to potentially trigger the default of a commodity firm, with the consequence that some of the financial institution counterparties of this firm themselves default. This is unlikely on the following grounds:

- (1) the share of pure outright commodity derivatives trading (as opposed to derivative trading used to hedge physicals) in a large commodity group’s balance sheet is relatively small. The commodity firms’ exposure to financial institutions and indeed the financial system is principally based upon their physical assets. In addition to core commodity firms, financial institutions may also trade with specialist commodity trading firms whose business is to provide hedging, credit and other facilities to physical market participants. Again, any pure derivatives trading exposure they may incur *will be* highly unlikely to be of such size that it will cause financial systemic risk.
- (2) financial institutions manage their exposure to commodity firms, and the commodity markets, prudently. It is in large part thanks to the appropriate mitigation of counterparty credit risk by financial institutions that Enron’s failure has had so little systemic impact on the financial markets. As stressed in a recent report published by the FSA, a particular focus of bank supervision should be the quality of financial institutions’ monitoring and management of exposure to the commodity sector.

On the basis of the above, we do not believe that default risk stemming from commodity firms’ pure trading activities has the potential to cause financial systemic risk.

- (iv) Turning to market risk as defined above, this is a risk mitigated by the number of players in the commodity markets, and the ability to maintain and/or quickly restore supply. Responsibility for the oversight of supply networks falls to the physical regulators. It would be inappropriate to subject commodity firms to prudential requirements because of a potential physical/operational failure.

The CDWG would also like to stress that high trading volumes do not necessarily imply a high degree of speculation in the commodity derivatives market. The core activity of most commodity firms or groups is the supply of physical energy and the management of production facilities. While these firms do vary their hedge ratio through trading, as long as the net trading position is smaller than the physical position or their asset holding a risk reduction effect is always achieved.

For example, if a commodity firm has a physical output of 100 bbl oil and sells 50 bbl on the derivatives market its hedge ratio is 50%. If it buys back 50 bbl its hedge ratio is 0% and it is again fully exposed to market risk. If it enters into the same string of transactions 10 times, its hedge ratio again is 0% and the trading volume has amounted to 1000% of the physical production. However, the market risk exposure is the same as if the entity had never stepped into the derivatives market.

The management of physical assets with optionality, such as power plants, also requires trading. For instance, a gas or coal based generating unit can be considered as an option to buy power at a strike price equivalent to its variable cost (fuel plus CO₂). When the forward market price is above the variable cost, the producer will sell its production forward. However, when the forward price is below the variable cost, the producer should buy back what he had previously sold, and sell the fuel and emission allowances instead. This will typically lead to a much higher volumes of power, gas and emissions being traded than the amounts needed for the physical production.

As long as such a commodity firm keeps its hedge ratio higher than 0% and smaller or equal to 100% risks are undoubtedly mitigated.

Question 14. Do you think that parts of the current prudential regulation (organisational requirements, capital adequacy, internal capital, etc.) should not apply in their present form to the provision of investment services in relation to commodity and exotic derivatives? Would your opinion depend on whether the respective services are provided by a firm exclusively providing services in commodity or exotic derivatives?

Question 15. If you consider some parts of the current prudential regulation should be adapted in order to be meaningfully applied to the provision of investment services in relation to commodity and exotic derivatives what are the reasons and what changes would you propose? Would the proposed changes depend on the type of entity providing the investment services or the underlying of the financial instrument?

We believe that specialist commodity firms warrant a prudential treatment which is distinct from that applied to financial institutions. Our detailed rationale for adopting this position is provided in Annex to this document. Specifically, we address the question of whether specialist commodity firms should be subject to minimum capital requirements (otherwise known as Pillar 1) in the same manner as banks. We strongly believe the answer is no and reach this conclusion by going back to first principles, i.e. by comparing the core financial activities of financial services firms versus the commercial activities of real asset firms, their respective capital structures, the nature of their client base (retail versus wholesale) and the risk posed by each type of firm to the financial system. We find a fundamental difference between specialist commodity firms and financial institutions, which justifies bifurcating their prudential treatment.

Finally, while we argue that specialist commodity firms should not be regulated via regulatory capital, we do believe that these entities should

- (a) be subject to controls, potentially through an appropriate degree of regulation; and
- (b) Maintain sufficient financial resources supporting their business exposures and risk taking activities.

In whatever manner these entities are legally organised in relation to their ultimate parents, the underlying financial resources must be shown to be sufficient to support the risk profile of the trading entity. Importantly, commodity firms form a heterogeneous group: some firms are large

and diversified in the type of underlying commodities that they trade, others are small and specialised. Whichever regulatory framework is applied will need to be scalable and proportionate to the risks posed by each regulated entity. Disproportionate requirements would crowd out the smaller players and cause the re-location of business outside of the EU, with adverse consequences for both the macro-economy and liquidity in the commodity markets.

We propose in the Appendix a prudential framework anchored in (i) the supervisory review of firms' risk management practices; (ii) the disclosure by firms of meaningful risk indicators to the general public. We believe this approach to be proportionate to the risks posed by specialist commodity firms to the financial markets, and to achieve the fundamental objectives of the Commission.

The CDWG would also like to add that the current CAD regime places constraints on the use of 'illiquid' physical assets to meet capital requirements in a manner that would place an undue burden on commodity firms. The majority of the assets a commodities firm holds on its books are physical assets which, although valuable and marketable, are discounted heavily by banking regulators and, in the case of intangible assets, are discounted completely³. As a result, many firms would be forced to raise additional regulatory capital at a significant cost, to meet the requirements of the regime. The undifferentiated application of organisational requirements, would represent a disproportionate burden for commodity firms (especially smaller (liquidity providing) players)).

Question 16, Do you think that activities giving rise to similar investor protection concerns should be, to the extent possible, subject to the same legal and supervisory framework?

Question 17. Do you think that parts of the current conduct of business regulation (client classification, information disclosure, fiduciary duties, etc.) should not apply in their present form to the provision of investment services and, in particular, the service of dealing on own account, in relation to commodity or exotic derivatives? Would your opinion depend on whether the respective services are provided by a firm exclusively providing services in commodity or exotic derivatives?

Question 18. If you consider some parts of the current conduct of business regulation must be adapted in order to be meaningfully applied to the provision of investment services in relation to commodity and exotic derivatives what are the reasons and what changes

³ e.g. the definition of collateral and the calculation of financial resources under the CAD regime recognise liquid assets (in general terms cash and primary market instruments), but generally place constraints on the use of 'illiquid' physical assets. The stock in trade of a commodity firm is commodities, therefore the majority of the assets it holds on its books (audited in accordance with local accounting standards) are warrants for physical metal or soft and agricultural commodities and physical assets - oil, petroleum products, LPG's, petrochemicals, gas in storage, coal in stock, electricity in storage (e.g. hydropower water storage facilities, nuclear loaded uranium fuel), generation, grid capacity, etc. These physical assets, although valuable and marketable, are discounted heavily by banking regulators and, in the case of intangible assets, are discounted completely. As a result, some firms may be forced to raise additional regulatory capital at a significant cost, to meet the requirements of the regime.

would you propose? Would the proposed changes depend on the type of entity providing the investment services or the underlying of the financial instrument?

One of our principal concerns is that the existing structure of MIFID fails adequately to recognise that the commodity and non-financial derivatives markets involve a wide range of market participants, whose business and risk profile is different from participants in securities and financial derivative markets. These market participants are mostly of a kind that do not require the kinds of protections that conduct of business regulation is designed to provide in financial markets; they deal with each other at arm's length and differ from investors in securities and financial derivatives as they are traders, producers or professional users of the commodities concerned or are seeking to hedge commercial or business risks. They do not require the intervention of financial regulators to protect them when they are pursuing their commercial objectives in entering into transactions.

MIFID does seek to introduce a degree of differentiation through its framework for business with eligible counterparties. However, that framework is based around securities markets and does not adequately reflect the different types of participants in commodity and non-financial derivatives markets.

In particular, the framework for defining eligible counterparties is too limiting in this context and excludes many active market participants. The size criteria for treating corporates as "elective" eligible counterparties are too restrictive because:

- they apply on an entity basis (rather than on a consolidated basis) – counterparties in the commodities business do not always prepare or are not willing to provide such information to enable firms to carry out any such classification for confidentiality reasons.
- they do not automatically treat listed/quoted companies as eligible counterparties;
- they do not cover many relatively smaller but important and expert participants in commodity derivatives markets; and
- it is unlikely to be possible to reclassify these corporates as eligible counterparties under the procedure in Section II Annex II (as applied by article 50 of the implementing directive), as those criteria are largely designed around individual investors operating on securities markets.

In addition, the benefits of the elective eligible counterparty regime are undermined by the fact that article 24(3) MIFID allows host states to restrict the ability of firms to treat counterparties as eligible counterparties.

Our preference, therefore, is that an exemption be applied, and made mandatory, for own account trading of commodity derivatives between professionals. We recognise that definition of 'professionals' would have to be considered at length here (we would propose an 'inclusive' approach to encourage development of liquid markets).

We have major reservations about application of MIFID, to the activities of these counterparties. At the minimum, were such regulation to be applied to these firms, the definition

of 'per se' eligible counterparties would need to include these participants, which are critical to these markets, by addition/amendment to MIFID Level 1 Directive Article 24(2).

In addition, the CDWG believes that it is contrary to single market principles and inappropriate for Member States to impose their own differing approaches to the classification of clients on firms conducting cross-border business (under article 24(3)).

Furthermore, the customer protection legislation that is subsequently applicable to any such small wholesale customer in commodity derivatives is irrelevant or impossible to apply as the trading entity provides no service.

The CDWG wishes to clarify that it is not calling for areas and activities covered by a binding exemption to include investment advice by commodity firms to clients, for which we recognise some form of MIFID regulation should apply.

We believe there is a strong case for application of a 'specialist' regime, taking into account the considerations detailed above, for commodity firms and areas of commodity firms' activities that are not covered by an exemption for own account trading between professionals.

We propose that this issue be considered carefully, and look forward to entering into a Dialogue with the Commission in this regard.

Question 19. Do you consider the scope of the definition of financial instruments provided for in MIFID as well as its implementing Regulation to be adequate?

The CDWG believes that the current definition of "commodity derivatives", as presently drafted, does not require further amendment (other than as set out in para 4) on the basis that it:

- i) includes commodity and "exotic" derivative contracts, whether cash-settled physically deliverable, (other than those falling within (ii) below), which are traded on or under the rules of an EU regulated market or a multilateral trading facility (MTF) or an equivalent third country market; and OTC contracts that are capable of being cash-settled or are equivalent to a derivative contract traded on or under the rules of an EU-regulated market or MTF, or an equivalent third country market; and
- ii) excludes physical "commercial purpose" commodity contracts, namely:
 - a. spot contracts (i.e. where delivery is to be effective within two days or the delivery period accepted by the relevant market);
 - b. "exotic" contracts that are not capable of being cash-settled;
 - c. contracts entered into with or by a grid operator for balancing purposes; and
 - d. "physical non-cash settled forward contracts" i.e. commercial purpose contracts that are intended to go to physical delivery, which do not include the option of cash settlement or exhibit the features of a financial derivatives transaction and which have been entered into for commercial purposes. (NB see particularly paragraph 2 below)

With regard to ii) d) above, unlike the case with spot transactions – which are the subject of an express exclusion from the scope of MIFID – physical non-cash settled forward contracts are not expressly excluded. While this has generated uncertainty on the part of some commodity market participants, it is our understanding, based on examination of MIFID, that the intention here is for exclusion of these contracts provided they are entered into for commercial purposes.

As stated in Paragraph 1 of this response to Question 19 of the CDWG, we are content with the current text, save only as follows:

- The term “forward rate agreement” should be deleted from the list of contracts set out in Section C(5), Annex 1 of the MIFID Level 1 directive on the basis that (a) there is no concept of a “forward rate agreement” in commodity market dealings and it (b) could be misconstrued as implying (in the absence of a specific exclusion) the inclusion of commodity forward contracts.
- The definitions of “commodity” in Article 2(1) of that regulation, currently apply only in determining the scope of commodity derivatives under paragraph C7 and “exotic” derivatives under paragraph C10 of Annex 1 to the MIFID Level 1 Directive. The CDWG suggests that it should be clarified that the term “commodity” in paragraphs C5 and C6 will have the same meaning as “commodity” in paragraph C7 of Annex 1.

In terms of miscellaneous points, the CDWG would make the following observations:

- There is a lack of definitional consistency between (i) different financial services directives that include the same business dealings (e.g. the definition of commodity / “exotic” derivatives as between MAD and MIFID) and (ii) those financial services directives and other statutory requirements which include the same business dealings, particularly the definition of commodity business as between MIFID and IAS 39. The CDWG believes that, while these are not issues that can be addressed in the context of MIFID, these inconsistencies will need to be resolved at some point in the near future.
- The inclusion of all options of physically deliverable commodities (i.e. not just options on commodity futures) may result in the imposition of a licensing / authorisation requirement on parties, even though (i) they are not engaging in any form of financial derivative dealings; and (ii) the options are executed solely for the purpose for and as part of their core commercial business (and not in the context of investment business). The Commission may wish to consider, in the light of Question 20, how this burden might be alleviated through the application of a “commercial purpose” test.

Question 20. If there are changes in the scope of persons falling under MIFID, how would it affect the definition of financial instruments in Section C(7), Annex I of MIFID? In particular, would you find the commercial purpose of a contract a useful distinguishing factor of whether the contract should be considered a financial instrument? If not, why not?

The Commission will recall that, during the course of negotiating the text of Level 1 and Level 2 directives, the industry believed that the “commercial purpose” test and the financial

derivative “characteristics” test were different in substance (i.e. the “commercial purpose” test is purposive and goes to the intention of the parties, whereas the “characteristics” test is more objective and goes essentially to the nature and terms of the contract) and in time of application. That said, the CDWG recognises and accepts that the Commission made the decision to merge these two tests and apply a single set of criteria.

While this part of the CDWG response to the Call for Evidence does not address the continuance, amendment or abandonment of current exemptions in Article 2 of Level 1 MIFID, there is no doubt that they have a direct impact on the scope of the Directive in terms of types of market participants and dealing activities and, in that context, they supplement the “commercial purpose” aspect of the definition.

The CDWG, as already mentioned, believes that exemptions from MIFID should be applied to own account trading between professionals. Commercial purpose may be a further “useful distinguishing factor” for determining whether or not a particular course of dealings should be caught within the scope of MIFID if the parties are not dealing on own account, and are not ‘professionals’. Since “commercial purpose” should be determined largely by the intention of the parties entering into the contract (and by any subsequent change in intention during the course of the contract), this could be used to exclude from the scope of MIFID dealings entered into for the purposes only of managing commercial or price-risk. The final decision on the value of this test, however, should be taken only after thorough review and impact assessment, and after certainty has been reached as to the types of commodity firm that may/may not be exempted from MIFID, and the overall impact of each of these decisions on the commodity derivatives market.

Question 21. Which type of information (depending on the particular market) do you consider to be essential to efficient competition in the provision of investment services in relation to spot commodities and commodity derivatives?

In general terms, the CDWG is supportive of the principle of maximizing transparency in the commodities market, though this should not hinder the competitiveness of firms, nor act as a factor inhibiting firms from participating in the market.

We underline that member firms of ISDA, the FOA and EFET are drawn from the ranks of commodity firms as well as financial institutions, and that neither of these groups believe that competition in investment activity in the spot commodities and commodity derivatives sector will be enhanced by application of new types of transparency obligations to the market via financial services legislation⁴.

The CDWG also notes that the preliminary findings of the European Commission’s review of pre- and post-trade transparency for all non-equity financial instruments suggests that there is no case for application of such requirements in the commodity derivatives sector.

⁴ Other than, possibly, via review of the Market Abuse Directive – see our response to question 25.

The CDWG is open to the idea of exploring whether market integrity rules should be revisited, with a view to ensuring parity exists in the market, at regards market conduct. Certainly, the CDWG believes that emphasis is best placed on this issue rather than on transparency rules.

Question 22. In which commodity or commodity derivatives markets do you think there is scope for improvements regarding the availability of information which is essential for the orderly functioning of the market?

The CDWG supports efforts towards greater transparency.

As mentioned elsewhere, we are open to discussion of market integrity rules as they concern trading of commodity derivatives on MTFs, in particular if inappropriate asymmetries in regulation applied to financial institutions and commodity firms exist. This issue will require careful consideration however, and any scrutiny in this context should involve broad consultation, and through impact assessment and cost-benefit analysis.

In principle, transparency in the underlying markets (physical commodity markets) should primarily be addressed by the applicable legislation. For example in the underlying power and gas markets the transparency issue should be exclusively addressed by energy market legislation (see below). The CDWG strongly support transparency initiatives in the physical markets – but not through financial regulation.

In respect of the underlying gas and power markets an intensive discussion of these information/transparency issues does exist already. A number of proposals of Industry Associations (e.g. EFET) and the European Regulators' Group for Electricity and Gas (ERGEG) have been made in this regard⁵.

Concerning market transparency in underlying markets (including spot markets), the issue of market transparency will probably be addressed by the expected so-called “3rd energy package” of the EU Commission (DG Tren). Therefore, additional financial regulation would lead to duplication in regulation, legal uncertainty and (probably) contradictions.

We stress that if transparency in the physical market is to be addressed (and we do not necessarily believe that it should be), it should not be addressed via financial regulation.

Question 23. Other than publication of pre- and post-trade data in relation to transactions in commodity derivatives markets, are there any other types of information disclosures (e.g. publication of aggregate data by major market places) whose introduction might be desirable to enhance market efficiency and stability?

⁵ Please see EFET papers on ‘Best Practice in Electricity Market Transparency’ (January 2007), ‘Improved Publication of Information to promote transparency in the European gas market’ (August 2006), ‘Transparency of information about the availability and use of infrastructure and the protection of competition in European wholesale power markets’ (May 2006), EGREG ‘Guidelines of Good Practice on Information Management and Transparency in Electricity Markets (August 2006) and the EURELECTRIC Position Paper on Market Transparency (as further to the request of the 12th Florence Forum) (February 2006)

We do not currently consider that there is a need for any further types of information disclosure for the sake of competition in relation to spot trading or commodity derivatives (other than the ideas in relation to market integrity described in questions 22 and 25), nor any urgent need for improvements with regard to availability of information for orderly functioning of these markets. We would also question any assertion to the effect that new information requirements imposed through financial regulation would provide a benefit worth the cost that would be imposed on commodity firms.

Again, we refer to and concur with the European Commission's consultation on pre- and post-trade transparency in non-equity markets, where the preliminary conclusion reached by the Commission is that there is no need for new measures in relation to mandatory transparency levels.

Question 24. Do you consider it appropriate and consistent with the need to uphold the integrity of the markets to ensure that all transactions in relation to commodity and exotic derivatives admitted to trading regulated markets are reported to competent authorities?

We are wary of any proposal to introduce broad transaction reporting requirements, recalling the current worrisome situation concerning transaction reporting under MIFID.

While regulated markets and MTFs have a formal responsibility to ensure the orderly running of the markets they operate, we believe that, in the absence of any cost-benefit analysis demonstrating the contrary, there is no case for duplicating this work by imposing transaction reporting to regulators on firms. Monitoring carried out by the regulated markets and MTFs (see below) may be sufficient to ensure that market integrity is upheld – although, of course, any move to introduce or amend legislation in this context should itself be subject to lengthy and careful consideration and consultation, as well as impact assessment and cost-benefit analysis.

Question 25. Do you consider the current market abuse regime in relation to commodity and exotic derivatives is satisfactory? If not, how would you propose to improve the current regulatory framework? In particular, to what extent would you consider it desirable to investigate the applicability of market abuse regulation in relation to trading of spot commodities?

We believe that the application of the current market abuse regime in relation to commodity and exotic derivatives is something which would benefit from further considered analysis at this stage in the interests of protecting and enhancing market integrity in these markets outside the scope of direct authorisation of participants. Bearing in mind the particular complexities of market abuse issues in the context of commodity derivative markets, as was noted by CESR in its advice on the Market Abuse Directive ((2003/6/EC) implementing measures, we would not be in a position to propose specific improvements without further careful consideration. One avenue that might be considered is examination of the Market Abuse Directive to determine

whether (inappropriate) regulatory asymmetries exist between commodity firms and financial institutions as regards market integrity rules relating to commodity and exotic derivatives admitted to trading on multilateral trading facilities (MTFs), though we stress that we are at a very early stage in consideration of this issue ourselves, and any move in this direction should be considered at length (and be subject to the usual better regulation and consultation caveats).

The CDWG would also be keen that any new market conduct legislation, or amended legislation in this context, should make allowances for the legitimate management of commercial risk by commodity firms (e.g. when an electricity firm has knowledge of a major power outage on its grid).

The CDWG reminds the European Commission that the sector-specific regulatory regime for the power and gas markets, as well as the supervision of DG TREN, DG COMP and the national regulators and competition authorities already represents a significant regulatory framework for these markets.

Question 26. Do you consider this classification scheme sufficient for the purposes of the review?

Yes.

Question 27. What information and data sources do you consider relevant to the issues raised in this call for evidence? Would you or your organisation be prepared to produce any relevant information or data if necessary?

The CDWG is deliberating over the possibility of commissioning a study on commodities trading markets, and the impact of different regulatory approaches on these markets. When a final decision has been taken on this matter, it will be communicated with the European Commission. Any findings from such a study will be communicated to the European Commission.

For more information please contact Roger Cogan at rcogan@isda.org

Annex 1 to Joint ISDA-FOA-EFET response to Call for Evidence on Commodities: An Alternative Approach to the Application of the full CRD to Commodity Firms active in the EU

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1. EXECUTIVE SUMMARY

The Commodity Firms Regulatory Capital Working Group (CFRC WG) proposes an alternative approach to the application of the full Capital Requirements Directive (CRD) to specialist commodity firms in the EU.

While commodity market participants recognize that they face many of the same risks as banks and investment firms in the course of trading in commodity derivatives, it is not true to assume that the financial impact of failure by a commodity firm will be the same as an equivalent failure by a financial institution. This lack of systemic impact on the financial system renders a minimum capital charge an inappropriate method of regulating specialist commodity firms.

Market participants believe that the imposition of an unmodified CRD will drive many firms to make changes in corporate structure which are at odds with best practice 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.

In order to address these concerns, the Commodity Firms Regulatory Capital Working Group proposes an approach that disapplies the need to hold minimum regulatory capital while utilising the flexibility of existing CRD internal review and public disclosure requirements (Pillar 2 and Pillar 3) to reduce risk in commodity markets.

The main features of this alternative approach are that:

1. the need for computing and holding regulatory capital is abandoned;
2. the approach leverages existing and proven risk management practices developed by commodity firms; and
3. the approach leverages off the disclosure requirements from accounting (IFRS), and develops requirements which are relevant to the commodity industry.

2. INTRODUCTION

The Commodity Firms Regulatory Capital Working Group (CFRC WG) is a joint task force set up by ISDA⁶, EFET⁷ and the FOA⁸ to discuss the prudential treatment of commodity firms in the EU. The London Investment Banking Association (LIBA) is represented on the WG in an observer capacity. The CFRC WG comprises 21 commodity firms active in the European energy and metal markets. The CFRC WG does not purport to represent soft commodity traders and recommends that the Commission and CEBS approach these firms separately. A full list of CFRC WG member firms is located in Appendix 1.

The arguments made in this paper build upon the considerations and concepts presented in the letter from the CFRC WG to the Commission dated 27th January 2006 (see Appendix 2). In that letter, we queried the rationale for the application of prudential regulation to commodity market participants. Insofar as no response to that letter has been forthcoming, we are seeking below to provide the Commission with a detailed analysis of why we feel that the regulation of commodity firms should not rest upon minimum capital requirements, but rather focus on good risk management practices and disclosure. We are looking forward to the Commission's own analysis of the case for submitting specialist commodity firms to prudential regulation, and would be pleased to discuss our assessment with DG Internal Market.

The CFRC WG addresses the question of whether trading entities associated with commodities firms should be prudentially regulated in the same manner as banks and other financial institutions through the use of a minimum regulatory capital requirement (Pillar 1). We strongly believe the answer is no and reach this conclusion by going back to first principles, i.e. by comparing the core economic activities of financial services firms versus real asset firms, their respective capital structures, the nature of their client base (retail versus wholesale) and the relative degree of systemic risk posed to the macro-economy by each type of firm. Regarding this last point, the key proposal is that, while different types of firms can agree to measure the same risk in the same way, the consequences to the macro-economy are likely to be very different should a specialist commodity firm as opposed to an investment firm fail. Therefore, the regulatory response should be different as has been and must continue to be recognised.

Finally, while we argue that trading entities embedded within commodities firms should not be regulated via regulatory capital⁹, we do believe that these entities should

⁶ ISDA represents participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has over 700 member institutions from 50 countries. 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 risks inherent in their core economic activities.

⁷ EFET is a group of 80 energy trading companies from 18 European countries dedicated to promoting energy trading throughout Europe.

⁸ FOA is an industry association for 170 firms and institutions carrying on business in futures, options and other derivatives. The FOA's membership notably includes financial institutions, commodity trade houses, energy market participants, fund managers, exchanges and clearing houses.

⁹ The CFRC WG does not contest the requirement under MiFID Recital 24 for firms exempt from the full CRD to hold a minimum level of capital, professional indemnity insurance or a combination of the two.

1. be subject to appropriate regulation; and
2. hold sufficient financial resources to support their risk taking activities.

In whatever manner these entities are legally organised in relation to their ultimate parents, the underlying financial resources must be shown to be sufficient to support the risk profile of the trading entity.

Importantly, commodity firms form a heterogeneous group: some firms are large and diversified in the type of underlying commodities that they trade, others are small and specialised. Whichever regulatory framework is applied will need to be scalable and proportionate to the risks posed by each regulated entity.

This section of the Paper is concerned with the general issue of minimum regulatory capital as espoused by Pillar 1 of CRD/Basel II and the applicability of this framework to the trading activities of commodities industry firms. The second section of the paper provides a proposed risk structure and disclosure framework for commodity market participants.

3. ARGUMENTS AGAINST A MINIMUM LEVEL OF REGULATORY CAPITAL FOR SPECIALIST COMMODITY FIRMS

The argument against the imposition of a Pillar I capital calculation on commodity market participants, and the corresponding elimination of capital add-ons in the Pillar II/ICAAP framework is based on two broad principles:

1. The imposition of a minimum capital charge on commodity market participants is an inappropriate method of mitigating the risks that the charge was initially conceived to address; and
2. Forcing commodity market participants to meet banking style capital requirements will likely drive adverse changes within the market and increase risk.

3.1 Principles of regulation

The paper ‘*Risk Management Guidelines for Derivatives, Basel Committee on Banking Supervision, July 1994*’ notes that:

“Recognising the importance of sound risk management to the effective use of derivatives instruments, the following guidance is intended to highlight the key elements and basic principles of sound management practice for both dealers and end-users of derivatives instruments. These basic principles include:

- Appropriate oversight by boards of directors and senior management;
- An adequate risk management process that integrates prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring and frequent management reporting; and,
- Comprehensive internal controls and audit procedures.”

These principles form the basis of the Pillar II process and in themselves do not necessitate a capital solution to the problem of risk.

A more recent publication from the The Joint Forum (BIS) entitled "Regulatory and market differences: issues and observations" (May 2006) has noted that (see paragraph 6)...

"The Joint Forum acknowledges that there may be very good reasons for sectoral differences in regulatory approaches to the same risk." and has concluded that...
"Consequently, the Working Group did not approach this assignment in the belief that cross-sectoral convergence in regulatory approaches is desirable in every instance."

While this work was exploring financial services/banking and insurance, the Joint Forum recognises that there is more to consider when defining an appropriate regulatory response than simply the nature of the risk or the need for equivalence in regulatory treatment.

The CFRC WG recognises that commodity market participants are subject to similar market, credit and operational risks as banks and investment firms dealing in commodity derivatives, albeit to different extents, and that specialist commodity firms frequently use the same risk measurement and mitigation techniques as banks. We do not believe, however, that the impact to the financial markets of the failure of a specialist commodity firm can be so broad or critical as to require the imposition of a regulatory capital charge.

3.1.1 Lack of systemic risk in commodity markets

The failure of a large bank or other financial institution may present a systemic risk to the financial system. The same is not true of specialist commodity firms.

It is well understood that banks and other financial institutions face externalities such as bank runs to which a non-bank is not normally exposed. The prevention of a bank run hinges on "confidence" and the fact that there is never enough liquidity (i.e. cash) to satisfy the demand that would be generated if every customer wanted their deposit back immediately (or even over a short time frame of say several days). Prevention of widespread damage to the financial system should such an event occur is the underlying requirement of banking regulation.

Further, the banks operate the payments system, which is the central transmission of value in the macro-economy and explains why these institutions are deemed as highly systemic. Other reasons include being systemic due to a chain reaction among interdependent institutions (e.g. because of the inter-bank netting process) and common exposure to a single counterparty (as exemplified by the LTCM case).

Commodities firms in the main do not have this type of inter-dependence amongst each other nor are they entangled within the macro-economy as in the manner of the banks, as they do not collect deposits and mostly if not exclusively trade with wholesale clients. Enron was a major commodity player in Europe prior to its demise; the firm controlled about one fifth of the European electricity trading market, including 40% of the German market. Yet, the collapse of Enron did not trigger a failure by a financial institution, or a major commodity firm. In a statement dated December 20, 2001, Standard & Poor's noted that direct financial loss at major European utilities following the Enron debacle appeared to be "limited as most counterparties maintained adequate credit management procedures". A similar conclusion was reached by the Congressional Research Service in a report published in January 2003 entitled "The ENRON collapse: an overview of financial issues". The fact that the "lights were still on" after the collapse of Enron strongly suggests a lack of systemic impact for all of the reasons previously mentioned.

Evidence from the Enron case is persuasive but still anecdotal; simply put it is hard to prove a lack of systemic risk. That there are no examples of systemic failure arising from the failure of a commodity firm is necessarily only part of the argument.

The key driver behind the lack of systemic financial risk in the commodity market is the existence of the physical underlying and frequently the supporting group infrastructure to continue extraction and sale of that underlying. In bankruptcy it is often possible to continue to operate the productive assets of a real asset firm (witness the case of airline companies) whilst the same actions are often not possible in the case of a financial services firm whose productive assets are intangible and very closely tied to its intellectual property and human capital of its workforce. Whether the commodity firm in question is part of a larger group including significant physical operations or a simpler specialist trading operation, the failure of that firm will do nothing to impede the ongoing extraction/production of the underlying commodity which will itself retain significant offsetting value.

We recognise that failure of a market maker in a given commodity would reduce liquidity within that market, but the imposition of a capital charge would do nothing to increase liquidity. Reduced liquidity would result from a failure of supply, which falls outside the jurisdiction of the financial regulators.

3.1.2 Capital ineffective for firms with low debt/equity ratios

The capital structure of these banks/investment firms is often markedly different to commodity firms, the hallmark of financial services firms (given their customer liabilities) being relatively high debt to equity ratios. Real asset firms, such as most commodity firms, by contrast have a relatively freer hand in determining their capital structure. It is observed that for example, utility companies operating in quasi-monopolistic environments have extremely high debt-to-equity ratios while commodities firms operating in competitive environments in general have much lower debt-to-equity ratios. Hence we propose that minimum regulatory capital as a

control device for risk-taking would be relatively ineffective, unlike in the case of a bank due to its already high debt-to-equity ratio.

3.2 Consequences of applying the CRD in substantially unmodified form

For the reasons set out above, Pillar 1 regulation appears to be neither appropriate nor necessary for commodity firms. The CFRC WG further believes that the imposition of a Pillar 1 capital charge on commodity firms would have negative consequences for the market as a whole.

3.2.1 Drives Changes in Corporate Structure At Odds With Best Practice

The core activity of commodity firms is not by nature financial, and it appears inappropriate to subject the whole balance sheet of the firms to the financially-orientated CRD. The CFRC WG, based on discussion with regulators, understands that the framework being contemplated would apply to the firms' trading business. Would a Pillar 1 capital charge be effective in this particular context?

Because Pillar 1 sets aside capital against a particular activity of the firm, it is likely that firms would seek to isolate this activity in separate legal entities. The Pillar 1 charge would not have much meaning otherwise, as it would be measured against own funds available to offset not just trading loss but all types of loss.

The subsidiarisation of trading activities can cause an increase in financial risk by reducing the effectiveness of established internal control processes. The extent to which risk will grow depends on the definition of the regulated activities, which itself is part of the MiFID review. Taking the current version of MiFID as a starting point and assuming that regulation focuses on commodity derivatives falling within the scope of MiFID, and therefore that their trading is subsidiarised, it is likely that natural hedges between derivative activities and core physical positions would be lost, resulting in higher exposure to market risk. Hedging this exposure with the mother company would potentially give rise to a large exposure for the subsidiary. Furthermore, if firms chose, as MiFID suggests, to separate between commercial and non-commercial derivatives, they would have to disentangle Master netting agreements at very significant operational cost. This, by reducing the scope of netting, would increase credit risk.

The subsidiarisation of trading activities, beyond the direct costs and risks that it causes, can also damage the reputation of a firm with its customers, who generally view the mother company as more credit worthy.

Yet more crucially, subsidiarisation would not keep the probability of default of the subsidiary under control, as failure by the parent company would probably trigger that of the subsidiary, unless the latter was completely ring-fenced. Some firms have already ring-fenced their trading activities but for other firms to do so would generate significant costs.

The CFRC WG does not believe that such costs should be imposed purely for the sake of regulation where evidence suggests that the regulation is unnecessary.

3.2.2 Barriers to Entry/Reduced Liquidity

Regulation should avoid yet another pitfall: crowding out the smaller players. It should be proportionate to the size and risks borne by the various market participants. The landscape is varied, with some firms engaging in large scale diversified trading, while others tend to specialise in certain markets or products. The regulators and the Commission should aim to devise a prudential framework which does not alter this landscape: setting the hurdle too high for the small and even medium sized players would damage liquidity and increase the financial risks to which the remaining firms are exposed.

3.2.3 Competition Issues Outside Europe

Because a number of key jurisdictions outside of the EU, most notably the US and Switzerland, regulate commodity derivatives trading more lightly than in Europe, it is key that whichever framework is devised in the EU is perceived by commodity firms to be proportionate. If the cost of regulation is too high, commodity firms will be tempted to re-locate some of their trading activities outside of the EU, as respondents to the CEBS survey on commodity business have made clear. This would cause job losses and stunt growth in the particular sector.

It is the view of the CFRC WG that the alternative approach (AA) described in the remainder of this memorandum strikes an appropriate balance without undermining the public policy agenda of financial regulation.

4. METHODOLOGY

In order to develop the alternative approach, the CFRC WG has sought both to establish the clear conceptual argument supporting the Approach, and to produce a coherent set of high level control objectives rigorous enough to form a basis for firms to develop their own detailed risk control and disclosure procedures under the Alternative Approach.

In constructing the proposed regulatory regime, the CFRC WG conducted a survey of selected members to ascertain current risk management practices and related disclosure. The results of this survey are summarized in Appendix 3.

Of the 17 working group members selected to participate in the survey, we received nine responses. Interviews were conducted with ten companies (including six that responded to the survey and an additional four companies). The interviews were to gain a more in-depth understanding of the risk management practices employed.

Section 7 presents the proposed regulatory requirements arising from this work.

5. SCOPE

Regulation should not have an impact on how firms organize their business and, in particular, should not compel firms to reorganize their company or group structure in ways which are commercially disadvantageous merely to meet regulatory requirements. We assume that the alternative approach would apply to the firm's regulated financial activities and hence to the commodity derivative trading activities as determined by MiFID i.e. the core part of the business to which the prudential framework being contemplated will apply, wherever those activities are located within the firm (e.g. held in a separate subsidiary, held within main balance sheet, etc). It would be the firm's responsibility to define the perimeter of regulation within the firm's structure, under supervision by the regulator.

6. THE ALTERNATIVE APPROACH

Given the inappropriateness of using regulatory capital as a control device and the fact that commodities firms are not systemic in the manner of the banks, our alternative approach focuses on good risk management principles and disclosure requirements, and proposes detailed and concrete standards which are relevant for our industry as opposed to copying-out from the CRD. The main features of this alternative approach are that:

1. the need for computing and holding regulatory capital is abandoned;
2. the approach leverages existing and proven risk management practices rather than simply copying what the banks do; and
3. the approach leverages off the disclosure requirements from accounting (IFRS) and develops requirements which are relevant to the commodity industry.

The CFRC WG understands that applying such a risk based approach might entail a more detailed regulatory dialogue between regulators and firms at the outset, but considers that the need for appropriate regulation of market participants is clear.

The workload for regulators reviewing commodity market participants under the proposed approach is unlikely to be more significant than it would be under the CRD, or even a regime restricted to Pillar 1 of the CRD: a detailed review of firms' market and credit risk models and processes would be required under Pillar 1, as many firms currently rely on market risk modelling and internal ratings, and would use these approaches to produce regulatory capital numbers. Ultimately, the Alternative Approach will not require a more intensive use of the regulators' resources than other possible regulatory approaches, but rather a shift in emphasis

from a pure compliance exercise towards a risk management review, which the CFRC WG considers a necessary, and welcome, corollary of the CRD.

7. STANDARDS FOR RISK MANAGEMENT AND DISCLOSURE FOR COMMODITIES TRADERS

This section sets out a proposed risk control and disclosure framework.

The requirements have been established to ensure that firms engaged in commodities trading have sound internal risk management practices, to protect their financial stability. They also provide for adequate public disclosure, to enable external parties to form a view as to the adequacy of the risk management practices and the level of risk being taken.

This document has been prepared based on information provided with reference to the following documents:

- Minimum Requirements for Risk Management (MaRisk), Federal Financial Supervisory Authority (BaFin), December 2005
- International Convergence of Capital Management and Capital Standards, Basel Committee on Banking Supervision, November 2005
- Amendment to the Capital Accord to incorporate market risks, Basel Committee on Banking Supervision, November 2005
- Senior management arrangements, Systems and Controls, FSA, December 2004
- Sound Practices for the Management and Supervision of Operational Risk, Basel Committee on Banking Supervision, February 2003
- Principles for the Management of Credit Risk, Basel Committee on Banking Supervision, November 1999
- Risk Management Guidelines for Derivatives, Basel Committee on Banking Supervision, July 1994

7.1 Risk management framework

The risks associated with commodity trading activities include market risk, credit risk, liquidity risk and operational risk.

- Market risk is the risk to a firm's financial condition resulting from adverse movements in the level or volatility of market prices.
- Credit risk is broadly the risk that a counterparty to a trade will fail to perform on an obligation to the firm.
- Operational risk is the risk of loss from inadequate or failed internal processes, from people and systems or from external events.
- Liquidity risk is the risk that the firm will be unable to meet its payment obligations (eg: on settlement dates or in the event of margin calls).

This document sets out requirements for sound management of these risks within commodity trading activities.

The key elements of a sound risk management framework include:

- Appropriate oversight by the executive board and senior management, including setting risk management strategy and risk appetite and establishing appropriate organisational structures;
- An adequate system of internal controls, including procedures for identifying, assessing, monitoring and controlling or mitigating risks; and
- Regular review of the framework and internal controls.

In addition, a key element of the minimum standards for commodities traders is to disclose sufficient information to external parties to enable them to form a view as to the adequacy of the risk management practices and the level of risk exposures being taken. The requirements for disclosure are described in section 7.10.

7.2 Overall responsibilities of management

7.2.1 Board responsibilities

The executive board should have responsibility for:

- Ensuring an adequate framework for risk management including principles for how risks should be identified, assessed, monitored and controlled or mitigated within the commodities trading operations. The framework should consider market risk, credit risk, operational risk and liquidity risk as distinct classes of risk.
- Defining the firm's appetite for risk taking within the commodities trading operations. The risk appetite should be set giving consideration to the financial resources available to the commodities operations, business strategies, management expertise and overall willingness to take risk.
- Reviewing and approving the policies and procedures developed by senior management to implement the framework and translate the risk appetite into a system of limits and controls.
- Re-evaluating the framework and risk appetite at least annually, considering changes in the risk profile of the business (changes in products, markets, operating environment) and the results of stress testing.
- Ensuring that the framework is regularly audited by appropriately trained and competent staff that are operationally independent of the risk management activities. The audit should review adherence to the policies of the risk management framework as well as the effectiveness of risk management processes and controls.
- Maintaining oversight of the significant aspects of the credit, market, liquidity and operational risks within the commodity trading operations. This will require a system of reporting on key aspects of the operation of the risk management framework and significant risk exposures. In particular, the board should be made aware of significant breaches of risk management policies, risk limits and loss incidents.
- Assessing, at least annually, the aggregate risks taken in commodities trading compared with the risk appetite and available financial resources. This should reflect the measurement of the risks considering possible unexpected losses and the output of stress tests.

7.2.2 Senior Management responsibilities

Senior management should have responsibility for implementing the framework for risk management approved by the board. In implementing the framework, senior management will have responsibility for:

- Ensuring an appropriate organisation structure, with appropriate level of independence between staff responsible for risk management and those responsible for trading and settlement.
- Ensuring an appropriate level of skilled resources for managing risk, with clearly assigned responsibilities.
- Ensuring that remuneration structures are aligned with risk management objectives, and do not encourage operating outside of risk appetite or risk management policies
- Developing policies and procedures for identifying, assessing, monitoring and controlling or mitigating risks that reflect the principles set by the board. The policies and procedures must cover market risk, credit risk, operational risk and liquidity risk management.
- Translating the risk appetite expressed by the board into a system of risk limitation strategies and controls.

Before engaging in trading activities, management should ensure that adequate operational procedures and risk control systems are in place. Appropriate approval should be obtained for any new trading activities.

Senior management should regularly evaluate the procedures in place to manage risk to ensure that those procedures are appropriate and sound.

7.2.3 Risk management functions

The firm should establish a unit (or units) responsible for measuring, monitoring and controlling risk, consistent with the established policies and procedures. The staff in this unit should be organisationally independent of those managing the trading and settlement activities.

The firm must ensure an adequate level of resources in the risk management unit with the necessary skills to have a complete understanding of the risks associated with all of the trading activities.

There must be an independent system for reporting exposures to both senior management and to the board of directors.

7.3 Risk management process

The firm should establish a process for identifying, assessing, monitoring and controlling or mitigating all material risks. The processes must specifically address market, credit, operational and liquidity risks. Specific requirements for managing each of these types of risk are set out in the sections below.

7.3.1 Risk appetite

The board must define an approach to determining the appetite for risk taking within the commodities trading operations. This approach must give consideration to the financial resources available to the commodity trading operations and the adequacy for covering all material risks at all times.

The risk appetite set by the board should be translated into a structure of limits, guidelines and other parameters used to govern risk-taking.

The firm must monitor actual risk taking relative to the established risk appetite and risk limits. This will require a basis for measuring the level of risk, in each risk class, being taken. The board and senior management must be provided with an integrated view of the risks being taken.

The firm must consider the results of stress testing when assessing the adequacy of available financial resources and the appropriateness of the established risk appetite.

The board must re-evaluate the risk appetite and related risk management policies at least annually, relying where appropriate on recommendations arising from review by the risk function.

7.3.2 Reporting

The firm must establish a system of reporting to senior management and to the board on key aspects of the operation of the risk management framework and significant risk exposures. Reporting must include any significant breaches of risk management policies or risk limits and any material loss incidents. Reports must address each of the risk classes including market, credit, operational and liquidity risk as well as considering the overall risk profile. The results of the stress scenario assessments must be reported.

Requirements for reporting on each type of risk are specified in sections 7.4, 7.5, 7.6 and 7.7 below.

7.3.3 Controls

The firm must ensure a sound system of internal controls, to promote efficient operations, reliable financial reporting and compliance with relevant laws, regulations and internal policies.

7.3.4 Review

The board and senior management have responsibility for re-evaluating the framework, risk appetite and risk management procedures, considering changes in the risk profile, activities and the market environment.

The risk management function should regularly re-assess the methodologies, models and assumptions used to measure and limit risk.

The framework must be regularly audited. Requirements are specified in section 7.9 below. Internal audit must be advised of any significant changes or weaknesses in risk management.

7.3.5 New activities, products and markets

The firm must have an approval process for new business activities such as new products or entry to new markets. Before approval, the risks should be considered by an area independent of front office and trading and all areas that will be involved in the operation of the new business activity. All relevant personnel (including trading, risk management, settlement, finance and

legal and audit where appropriate) must have an opportunity to review and understand the product.

Where appropriate, the firm should conduct a test phase where trading is limited to a manageable scale. Appropriate risk measurement and control systems should be in place and approvals obtained before continuous trading commences.

7.4 Market risk management

The firm must have a framework for identifying, assessing, monitoring and controlling or mitigating market risk consistently across the trading activities. This must include a robust system for measuring market risks and monitoring the risks taken against an established system of limits. The limits must be set according to the risk appetite of the firm.

7.4.1 Identifying and assessing market risk

The firm must establish a basis for measuring the possible impact on financial resources from adverse changes in market prices for commodities, exchange rates and other market conditions that are relevant. The risk assessment should reflect the price volatility of the different positions.

The approach to measurement should be appropriate given the nature and scale of the trading operations. Firms may use a 'value at risk' approach, measuring the potential gain or loss in a position or portfolio associated with price movements of a given probability over a specified time horizon. The horizon set for the 'value at risk' should reflect the time it would take to close out the positions held. The probability, once calculated, should be considered when reviewing the firm's risk tolerance. Such models must be independently validated. The models should be periodically backtested and assumptions reviewed.

The approach adopted for measuring market risk must be sufficiently accurate and rigorous and be integrated into the risk management process, so that all market risks can be quantified, monitored and controlled.

All transactions exposing the firm to market risk should be included in the risk measurement. Positions with a current market price should be revalued daily.

The firm must be able to consolidate the risk measures into an overall risk position, in a manner suitable for comparison with any established limits.

Firms engaged in physical delivery of commodities should consider their capacity to deliver against commitments when setting risk appetite and assessing risk exposures.

The measurement approach used must be understood by relevant personnel at all levels from individual traders to the board. The risk measurement system must be well documented.

The risk management function should regularly re-assess the appropriateness of methodologies, models and assumptions used to measure risk and limit exposures. The frequency of such reviews will depend on the pace of change in the market and innovation in techniques to measure and manage risk, but should be performed at least annually. The assumptions in the models should be re-evaluated on a regular basis.

7.4.2 Controlling and mitigating market risk

The firm must establish a system of limits and guidelines for market risk-taking that are consistent with the market risk measurement approach and are appropriate to contain the risk within the tolerance or risk appetite set by the board.

It is expected that a firm would establish an overall limit for market risk and that limits would be allocated down to units or individual decision makers. The limit system may include volume limits, stop loss limits or other guidelines for controlling risk.

The limits must be clearly understood by all relevant parties. The firm must establish procedures for dealing with limit breaches, including any procedure for authorising positions in excess of limits.

The firm should not enter into any transaction bearing market risk without an established market risk limit. Before considering new types of transactions bearing market risk, the firm should establish an appropriate method for measuring and limiting the risk.

7.4.3 Monitoring market risk

A firm must have a procedure for monitoring market risk taking. Transactions that incur market risk should be captured in the risk measurement system daily and counted towards the corresponding limit. The risk management unit must produce and analyse reports of the risk measures and compare with risk limits at an appropriate frequency. Individual traders should be informed as soon as possible of the relevant limits and their utilisation.

Any positions taken that exceed limits should receive prompt management attention, in accordance with the firm's procedures. Exceeding limits must only be approved by authorised personnel.

Overall risk positions, results and limit utilisation should be reported daily to management of the risk control function and to managers that supervise the trading area. Reports must be easily read and understood by senior management and directors who may not have specialised technical knowledge of the products. Reports should advise any changes to key assumptions or parameters in the risk assessment.

Instances of substantial limit breaches should be reported to a level of management with authority to enforce reductions of positions taken by individual traders or the firm's overall risk exposure.

Management should periodically review the appropriateness of limits structures.

7.5 Credit risk management

The firm must have a framework for identifying, assessing, monitoring and controlling or mitigating counterparty credit risk consistently across the trading activities. This must include defined credit granting criteria, a robust system for measuring credit risk and monitoring the risks taken against an established system of limits. The limits must be set according to the risk appetite and financial resources of the firm.

7.5.1 Identifying and assessing credit risk

The firm should identify the credit risk inherent in the counterparties with whom they trade.

7.5.2 Granting credit

The firm should define criteria for granting credit, setting out the types of credit available, eligibility criteria, the terms and conditions including for example the types of collateral that are acceptable.

The firm should have a formal evaluation and approval process for the granting or renewal of credit. Before granting credit, the firm should obtain sufficient information to assess the risk of the counterparty being unable to pay or deliver on trades, as well as identifying if counterparties are connected. While collateral and guarantees can be used to mitigate credit risk, decisions to offer credit should be assessed primarily on the risk profile of the counterparty.

The firm should maintain files on the credit decisions, limits established and collateral agreements, and maintain information to ascertain the current financial condition of the counterparties.

7.5.3 Measuring credit risk

The firm should establish a system of rating counterparties for their probability of default on payments or delivery. The ratings assigned to individual counterparties should be reviewed by staff independent of the front office.

The firm should establish a basis for measuring the possible impact of unexpected losses on financial resources from counterparty default. The measurement of credit risk related to trading transactions should take into account the exposure profile until maturity, potential market movements, the value of collateral or guarantees and the risk rating.

The risk measurement should also consider the exposure in margin agreements, considering counterparty vulnerability to liquidity stresses.

Measurement techniques should be appropriate to the complexity of the transactions and the level of risks involved.

The firm must be able to assess aggregate credit risk exposures.

The measurement approach used must be understood by relevant personnel at all levels from individual traders to the board. The risk measurement system must be well documented.

7.5.4 Controlling and mitigating credit risk

7.5.4.1 Credit risk limits

The firm must establish a system of limits and guidelines for credit risk taking, consistent with the credit risk measurement approach. The limits should be set according to the risk appetite and adequacy of the available financial resources.

Limits for individual counterparties may be related to the internal ratings assigned. Limits should also be established for relevant aggregations or concentrations of credit risk.

Limits should be periodically reviewed by staff independent of those responsible for approving the credit.

Trades should generally only be executed with counterparties if a counterparty credit risk limit has been established.

7.5.4.2 Credit risk mitigants

A firm may use master netting agreements and various credit enhancements, such as collateral or third-party guarantees, to reduce its counterparty credit risk.

The measure of credit exposure should reflect these risk-reducing features to the extent that agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty.

The firm should have procedures for monitoring, administration, valuation and realisation of collateral, by a unit independent of front office.

If the value of the collateral is dependent to a substantial degree on the financial situation of a third party, the firm must review the counterparty risk for that party.

With regard to guarantees, the firm should evaluate the risk profile of the guarantor.

7.5.5 Monitoring credit risk

A firm must have a procedure for monitoring credit risk taking against the established limits. Transactions with a counterparty must be counted immediately towards their limit. The firm must be able to analyse the credit risk for individual counterparties and in aggregate, to identify particular sensitivities or concentrations.

Individuals responsible for managing the positions must be informed of the relevant limits and their utilisation.

Any positions taken that exceed limits should receive prompt management attention. Exceeding limits must only be approved by authorised personnel. Significant breaches should be reported to the responsible managers on a daily basis.

The firm must have procedures for dealing with problem credits.

The risk management function should produce reports of the extent of limits granted, aggregate exposures, large exposures, material limit breaches, instances of default or significant changes to the risk of key counterparties, high risk or complex transactions and breaches of policy.

7.6 Operational risk management

Operational risk is the risk of loss from inadequate or failed internal processes, from people and systems or from external events. Examples include internal and external fraud, improper trading activities, transaction processing errors, failings in collateral management, events impacting

delivery of physical commodities, damage to physical assets, workplace injuries. Operational risk differs from other classes of risk, such as market risk and credit risk, in that it is not generally taken in return for an expected reward, but exists in the normal course of a firm's activities.

The scope of the operational risk requirements depends on the MiFID scope, for example whether physical transactions are included.

Firms should consider operational risk as a distinct class of risk and develop specific structures and processes aimed at managing operational risks. The definition of operational risk adopted by the firm should be clearly communicated to management throughout the firm.

Firms must establish policies and procedures for identifying, assessing, monitoring and controlling or mitigating operational risk within trading activities. The appetite and tolerance for operational risk can be established through the stringency of policies and the prioritisation of risk management activities.

Management will have accountability for the appropriateness and effectiveness of the business processes within their scope. Accountabilities for managing the operational risks within each area must also be clearly assigned.

Staff responsible for managing operational risk should interact with staff managing credit, market and other risks to avoid gaps or overlaps in risk coverage.

7.6.1 Identifying and assessing operational risk

On an ongoing basis, management must identify material operational risks within the trading activities, considering internal and external factors that could adversely affect the achievement of the firm's objectives. Where a firm's trading activities involves the physical delivery of commodities, the risks to delivery should be considered. Management should assess the firm's vulnerability to these risks. The assessment should be used to prioritise management action.

Before new products or new activities are introduced, the firm must ensure that the operational risks are assessed and considered.

The firm's stress tests must consider extreme but plausible operational risk events.

7.6.2 Controlling and mitigating operational risk

Management must ensure that adequate procedures are in place to mitigate or control the operational risks. Control activities must be integrated into the processes of the firm. A firm should ensure that processes and controls are documented and understood by the relevant staff. Documentation must be amended promptly to reflect any changes to processes. Particular care must be taken to comprehensively document transaction handling processes and transaction processing systems.

Specific controls required for trading activities are outlined in section 7.6.4 below.

To avoid conflicts of interest and the risk of inappropriate actions, errors or losses being concealed, the firm must ensure an appropriate segregation of duties. Areas of potential conflicts of interest should be identified, minimised and subject to monitoring and review.

7.6.3 Monitoring operational risk

A firm must have procedures for monitoring compliance with management controls, such as adherence to assigned market or credit risk limits. The adequacy and effectiveness of such procedures should be regularly reviewed and tested, in light of the overall risk appetite and profile.

Management must monitor the overall operational risk profile and exposures to potential losses, to detect and correct deficiencies in risk management processes and controls. The firm should identify indicators that provide early warning of increased risk of operational incidents or losses. The firm should consider the threshold for such indicators, to prompt management action. The frequency of monitoring should reflect the risks involved and the degree of change in the operating environment.

A firm must have procedures in place to identify any material operational risk incidents and direct management attention accordingly. The risk management unit should identify the cause of any material operational risk incidents and review the adequacy of risk management controls.

There should be regular reporting of material operational risks and incidents to senior management, including the areas on which the risks may have an impact. Reports should identify any problem areas and motivate timely corrective action on outstanding issues. Reporting of incidents should outline the cause, the type and scope of loss and countermeasures that have been introduced. Reports should be used with a view to improving existing risk management performance as well as re-evaluating risk management policies and procedures.

7.6.4 Controls over trading

A firm requires sound operational controls over trading and settlement to limit the operational risks. This section provides specific requirements for such controls.

7.6.4.1 General trading requirements

The terms and conditions of all trades must be agreed in full.

When trades are completed, all of the relevant transaction data must be recorded immediately. This should be passed on to the settlement function together with all documentation. The transaction data may be transferred automatically by a settlement system.

Where data is recorded directly in an IT system, care has to be taken to ensure that a trader can enter transactions solely under his own trader ID. The recording date and time as well as the transaction's serial number are to be entered automatically by the system and must be impossible for the trader to alter.

The legal enforceability of any trading agreements, such as master agreements, netting agreements and collateral agreements, should be assessed by a unit independent of trading.

Firms must establish schemes of delegation requiring appropriate authorisation for the transfer of funds independent of the trading function.

7.6.4.2 Settlement and control

Every trade must be confirmed at the prescribed time in writing (or equivalent form) including relevant transaction data. Controls are required to ensure that counter confirmations, if received, are received on a timely basis by the settlement function. Missing or in-complete counter-confirmations must be reported to the counterparty immediately, unless all parts of the trade in question have been executed correctly.

If trades are cleared via a settlement system, confirmation may not be required providing the settlement system

- automatically reconciles the relevant transaction data ("matching") and executes trades only where the data matches or
- allows both counterparties access to monitor the transaction data at all times

Transactions should be monitored to ensure:

- documentation is complete and submitted promptly
- transaction data supplied by traders is accurate and, where available, matches the data in the brokers' confirmations, outputs from trading systems or other relevant sources
- they fall within the defined limits on their type and scope
- the terms agreed are in line with market conditions or internal policies, and
- any deviations from predefined standards (e.g. master data, delivery instructions, methods of payment) have been agreed.

Any deficiencies identified should be reported to management.

Any discrepancies identified during settlement and control has to be remedied immediately by an area independent of trading. Cancellation of trades or changes to transaction data must be assessed by an area independent of trading.

Trades, including ancillary agreements which result in positions, have to be covered by the risk control function immediately.

7.6.5 Information technology systems

The firm should have clearly formulated policies for controlling information technology (IT) system risks. These polices should be documented and communicated to all relevant personnel.

The firm should conduct an analysis of IT risks and ensure adequate controls for:

- protecting against unauthorised access
- ensuring availability of systems
- ensuring accuracy, completeness and timeliness of information

IT systems must be tested before they are used and after any material changes. Testing should be performed by IT staff as well as the staff responsible for the relevant processes. Production and testing environments should be kept separate.

7.6.6 Business continuity

The firm should develop contingency plans to ensure their ability to operate on an ongoing basis and limit losses in the event of severe business disruption. Such plans should take into account different types of plausible scenarios to which the firm could be vulnerable.

The firm should identify the critical business processes that need to be resumed rapidly and determine alternative mechanisms for resumption, paying particular attention to the ability to restore electronic or physical records.

The firm should test and review these plans on a regular basis to make sure that they operate satisfactorily and review plans as required.

Plans should be made for the communication channels to be used in the event of an emergency and should be communicated to staff.

7.6.7 Outsourcing

A firm considering outsourcing any of the processes of the trading operations must assess the operational risks involved and the adequacy of controls, giving particular consideration to the ability of the firm to ensure ongoing assurance over the soundness of controls.

Outsourcing arrangements should be based on robust contracts and / or service level agreements that ensure a clear allocation of responsibilities between the service provider and the firm.

7.7 Liquidity risk management

A firm must ensure that it can meet its payment obligations at all times.

As appropriate, a report must be submitted to management on a regular basis providing a liquidity overview, covering an appropriate period of time, comparing expected inflows and outflows and specifying the assumptions.

The analysis of liquidity risks should consider stress tests to determine the extent to which the firm can cover liquidity requirements in various extreme scenarios, considering the sources of liquidity available and any shortfalls.

Management should consider the actions that would be taken in the event of a liquidity squeeze and document the contingency plans and the communication channels that will be used.

A firm should consider the possibility that it could lose access to one or more markets, either because of concerns about the firm's own creditworthiness, the creditworthiness of a major counterparty or because of generally stressful market conditions. A firm may be required to deliver collateral or settle a contract early at a time when the institution may face other funding and liquidity pressures. The liquidity plan should reflect the firms' ability to turn to alternative markets or to provide sufficient collateral or other credit enhancements in order to continue trading under a broad range of scenarios.

At least annually, a firm should analyse a range of stress situations as a supplement to its risk measurement models, and assess the ability of the firm to withstand them. Such analysis should consider a combination of extreme but plausible events in all major types of risk including market, credit, operational and liquidity, based on the characteristics of the firm's portfolio. The portfolio should be tested against past periods of significant disturbances.

The analysis should:

- assess the impact of adverse movements in such risk parameters as economic indices, commodity prices, market prices of discount instruments, exchange rates or sudden changes in market liquidity
- assess the linkages between different categories of risk that may emerge in times of crisis, such as high correlation between credit and market risk and the compounding effects

Management should evaluate the capacity of available financial resources to absorb such large losses and should identify steps that could be taken to reduce the risk and mitigate losses.

The results of the stress tests must be routinely communicated to senior management and the board and used in the assessment of the adequacy of available financial resources, and reflected in the policies and limits set.

7.9 Internal Audit

The board should ensure that the firm's risk management framework is subject to effective and comprehensive internal audit. The scope and frequency of reviews should be based on a careful risk assessment. As a general rule this should be annually for key processes, and cover all areas within every three years. If significant changes have occurred, or weaknesses have been identified, the frequency should be increased.

A comprehensive audit plan should be prepared each year and approved by management.

7.9.1 Internal audit function

The internal audits should be performed by appropriately trained and competent people, independent of risk management and business activities. The staff responsible for internal audits may provide input, but should not be directly responsible for risk management or business activities.

The staff performing internal audits must be granted full and unlimited access to review information and documentation of activities, processes and systems.

As a general rule, internal audit duties should be performed by employees of the firm or group.

7.9.2 Outsourcing audit activities

Internal audit activities may be transferred to external partners if the risks are acceptable or if the establishment of an internal audit function would be unreasonable due to the size of the firm.

Activities of the internal audit may only be transferred on the basis of a written audit request. The firm must be satisfied that the external provider has sufficient knowledge and capacity to perform the auditing properly.

Management must appoint an audit representative, internally, to ensure that the auditing meets the required standards. The audit plan and overall audit reports should be prepared jointly by the audit representative and the audit provider.

7.9.3 Scope of review

The scope of the internal audit plan should include evaluation, with appropriate frequency, of:

- The independence and effectiveness of risk management functions
- The adequacy of documentation of risk management systems and processes
- Compliance with and the effectiveness of risk management processes and internal controls, particularly processes for measuring, monitoring and limiting risks
- Integrity of the management information systems and the accuracy of records
- Reliability and timeliness of information reported to senior management and the board

In particular, review of trading processes and controls should consider:

- Transaction processing
- Recording of trades
- Settlement processes
- Accuracy of records
- Revaluation process and the sources of revaluation prices
- Market risk limit management
- Credit approval processes

Internal audit must be informed of material changes to risk management processes and relevant management decisions. Internal audit should be brought into the product development process at the earliest possible stage and should be required to validate any changes in the risk management or measurement systems.

7.9.4 Reporting

Internal audit must produce a written report on each audit as soon as possible to the responsible managers, including the subject of the audit, the findings and planned measures to correct any deficiencies.

Audit reports and procedural documents must be kept for 6 years.

If severe deficiencies are identified, these should be reported by internal audit to senior management. In severe cases, the supervisory body should be notified, providing a concise report on the deficiencies and the measures resolved to remedy them.

If management of the unit that was the subject of the audit does not agree with the measures identified to rectify any deficiencies found, they should submit an official statement to audit.

Internal audit should assess whether deficiencies identified are remedied within the required period and, if required, perform a follow up audit. If major deficiencies not remedied, the head of internal audit must inform the manager concerned in writing. If deficiencies remain unresolved, this should be reported to senior management.

Internal audit should prepare an overall report for senior management and the board on all audits performed in the year, covering the material deficiencies and measures taken and whether the audit plan was adhered to.

7.10 Disclosure

A key element of these standards for commodity trading is the public disclosure of risk management practices and risk exposures. Public disclosure enables parties that deal with each firm to form a view as to the adequacy of the risk management practices and the extent of risk relative to the financial resources of the firm. Lack of transparency has been a key factor in the demise of ENRON; the CFRC WG strongly believes that disclosure requirements can help avoid the recurrence of such events of default.

Firms may use their discretion for the appropriate medium for disclosure. This may be together with disclosures made under accounting requirements or listing requirements or through the firm's publicly accessible internet website, providing all the relevant information is available together.

Disclosures may be made in respect of the group within which the trading entity resides to the extent that the risk management framework of trading entity is integrated within that of the group.

The firm must have a process for verifying and approving the disclosures to be made. Firms must disclose the verification procedures adopted, such as validation by external auditors.

The firm must provide a statement of:

- The name of the entity to which the framework applies
- The name of the entity or entities trading in commodities
- Any restrictions on the transfer of funds or amount of capital available to the trading entity
- A summary discussion of the approach to assessing the adequacy of financial resources available to support current and future activities
- Arrangements for governance and oversight of risk management, including the responsibilities of the board and senior management
- Organisation structure for risk management responsibilities, with particular reference to the independence of risk management activities from trading activities
- Approach to setting the risk appetite for the trading activities
- Policies for hedging or mitigating risks

7.10.1 Market risk

A firm must, at a minimum, provide a statement of:

- The methodology used for measuring market risk
- The structure of limits used for controlling the level of risk taking
- The value of the overall limit set by the board or senior management
- The value of the highest, lowest and average market risk measure over the year, to give an indication of the level of utilisation of market risk limit
- Limits and values by commodity to the extent that these are not deemed confidential
- The approach taken for stress testing and the use made of stress test results

7.10.2 Credit risk

A firm must, at a minimum, provide a statement of:

- The methodology used for measuring credit risk exposures
- The methodology used for assigning credit limits for counterparty credit exposures
- The approach to rating counterparties
- The policies for use of margining agreements and collateral or guarantees
- The policies for use of netting agreements

The value of exposures to counterparty credit risk and the value of any defaults in the period, by key risk factors such as counterparty rating category and geographic region to the extent that this does not result in the release of commercially sensitive information deemed likely to disadvantage the firm.

7.10.3 Operational risk

A firm must, at a minimum, provide a statement of:

- The approach to the identification, assessment, management and monitoring of operational risk
- Procedures for identifying and responding to material operational risk incidents
- The internal structures for governance and oversight of operational risk

7.10.4 Liquidity risk

A firm must, at a minimum, provide a statement of:

- The methodology used for assessing liquidity requirements
- The total availability of liquid resources
- The approach to stress testing

Disclosure should also state the extent to which these resources are pooled with other entities within the same Group.

APPENDIX 1 – CFRC WORKING GROUP MEMBERSHIP LIST

Accord Energy

Amalgamated Metal Trading

Becker Buttner Held

BP

Clifford Chance

ConEnergy - Energy Commodities Traders Group

ConocoPhillips

E.ON Sales & Trading

ED & F Commodity Advisers Limited

EDF

EFET

Electrabel

Endesa

Eurelectric - Union of the Electricity Industry

European Energy Exchange

FOA

Gaselys

Gide Loyrette Nouel

Hess Energy Trading Company

ISDA

Koch Metals

LIBA

Nuon Energy Trade & Wholesale

RWE Trading

Sempra Metals

Shell/Stasco

Syneco

Total/Totsa

Triland Metals

Vattenfall

VDEW - German Electricity Association

Vitol

Appendix 2 – Letter to the European Commission dated 27th January 2006

Mr Peter Smith
Financial Institutions F2
Internal Market DG
European Commission
Avenue de Cortenberg
107, B-1049 Brussels
Belgium

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),¹⁰ 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.¹¹ 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.¹²

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

¹⁰ Under article 65(3) MiFID and article 45d(2) of the Capital Adequacy Directive (CAD), as recast by the CRD.

¹¹ I.e. those derivative contracts referred to in Annex 1 Section C points 5, 6, 7, 9 and 10 of MiFID.

¹² Under article 65(3) MiFID

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.

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 Sebton, Anthony Belchambers or Martin Spanier at esebton@isda.org; belchambersa@foa.co.uk; or martin.spanier@syneco.net.

Yours sincerely,



ENDESA, Sociedad Anónima
Director de Regulación
Juan José Alba Rios

Emmanuelle Sebton

Anthony Belchambers

Juan José Alba Rios

Senior Director

Chief Executive

Director Regulation

ISDA

FOA

EFET

Appendix 3 – Summary of survey results

1. THE SURVEY

A survey and interviews of selected members of the Commodity Firms Regulatory Capital Working Group was conducted in order to ascertain current risk management practices and related disclosure.

Of the 17 working group members selected to participate in the survey, nine responses were received. Interviews were conducted with ten companies (including six that responded to the survey and an additional four companies). The interviews were to gain a more in-depth understanding of the risk management practices employed.

This Appendix summarises the findings of the survey and interviews.

2. ABOUT THE PARTICIPANTS

Most participants trade in power, oil, coal and gas, while other commodities traded include metals, plastics, freight, weather and emissions. The types of contracts include spot, forwards, futures, options, usually requiring physical delivery of the commodity, as well as swaps, spreads, caps, collars. Transactions may be over the counter or on exchange. Most of the companies undertake proprietary trading, or undertake trading on behalf of other entities in the group. Only a few firms have a policy of restricting trading to mostly hedging.

Not all companies isolate the trading activity into a separate legal entity. In some cases, trading is performed as part of a larger legal entity, involved in the production or supply of the commodity. Where there is a separate entity for trading, they frequently act as agent for the rest of the group. In one instance, the entity operates as a commodities broker, providing broking services to external customers.

3. CURRENT REGULATORY REGIME

The trading activities of the companies surveyed are subject to a range of different regulatory regimes in different jurisdictions across Europe. The diversity in respondents has also meant that even within the same country the regulatory regime which they would need to comply with differs. For example, some UK respondents are governed by FSA SYSC Chapter 3, while others are covered by EMP and OMP regimes and have successfully received waivers from SYSC Chapter 3. Some German companies that are currently not under supervision have voluntarily chosen to comply with BaFin MaRisk requirements.

It was generally agreed that the regulatory capital requirements of CRD would be onerous if applied as they do to banks, and that companies may have to consider restructuring their operations to isolate the trading activities, adding considerable expense and complexity.

Commodity trading firms frequently use collateral and netting agreements, yet the recognition of these might not be adequate in the existing banking rules.

4. **RISK MANAGEMENT FRAMEWORK**

All of the firms have a framework for risk management, covering credit and market risk, and in most cases, operational risk. Yet the degree to which the management of these risk classes is integrated varies.

In most cases the framework is approved and reviewed by the board and in all cases, the principles and policies of the framework are documented.

A key aspect of governance is periodic audit of the framework, which is observed by all but one of the respondents.

5. **GOVERNANCE STRUCTURE**

Most of the respondents' highest risk committee is attended by Board members. In addition to the Group level risk committee, many respondents also have a Credit Risk Committee and Market Risk Committee with the responsibility of setting limits and monitoring exposures. In some cases, where the committees are at Group level, executives of the trading entity are required to sit on the committee.

Organisations generally have a risk control or middle office function, independent of trading, responsible for monitoring the risk exposures. Only half the firms have a separate credit risk function. Few firms have specific operational risk functions. Some firms have compliance functions. In all cases, the staff in these functions communicate with each other to avoid any gaps or overlaps in coverage.

All of the firms segregate duties appropriately to avoid conflicts of interest.

6. **CAPITAL ADEQUACY**

A majority of the respondents perform some kind of capital adequacy assessment against the risks, but in many cases this is firm wide, including activities beyond the trading. Of those interviewed, most do not explicitly relate VaR limits to the available capital. One firm mentioned that they actively change the capital allocated to trading according to the risk profile. Generally, the risks within the trading activities are a small part of the overall group risks.

Only half of the respondents carry out stress-tests to assess the impact on capital of extreme events. Most of the stress tests focus on market risk of the trading activities. Some of those interviewed, that are already doing stress tests need to do further work to consider operational risks. Where stress tests are performed, firms mentioned that they assess appropriate management action.

Interviewees mentioned that the economic shock scenarios mentioned in banking regulation are not appropriate to commodity trading.

7. **REPORTING**

All respondents undertake regular risk reporting to the board, senior management and risk committees. For the majority this includes reporting on credit, market and operational risk, although a number of these do not report on the latter.

Only two firms examined remuneration policies to ensure that these were not inconsistent with the risk appetite policy (ie that exceeding limits was not being rewarded).

8. **MARKET RISK**

Market risk management is well established in the trading operations. All firms have market risk management policies for measuring and monitoring market risk against established limits.

In most cases, the limits are set by a risk committee. Firms tend to establish a global market risk limit which is cascaded down to desk or product level. One firm mentioned that their position limits are very large and don't provide a constraint and need to be reviewed. Some firms mentioned that their limits were set and rarely reviewed, although some do look at the historical utilisation of limits and stress tests when reassessing. Most do not directly relate the limit to available financial resources. Some firms mentioned absolute limits for delta and Greeks as well as stop loss limits.

All respondents use a risk management system for transaction capture and monitoring limit utilisation. All but one respondent uses a VaR methodology for measuring market risk, revaluing positions daily, although we noted instances where some products, such as long term contracts, are excluded from VaR calculations. In these cases, separate add-ons are determined. There is variation in the probability and holding periods and length of history used. One participant is implementing intra day VaR within the next 2 years. A few firms elaborated on their approach to validating VaR models. This included testing against parametric methods over a period and back testing of results and board or management approval.

Controls processes are in place across all firms to ensure that all transactions are assessed against relevant limit availability. The survey also indicates that all firms have some form of reporting and escalation processes in place for limit breaches.

All but two respondents produce sensitivity analysis on their portfolios.

Some firms undertake back-testing by for example downloading historic data from Bloomberg.

9. CREDIT RISK

Credit risk arises where transaction payments do not occur until a date in the future. Credit risk due to fluctuations in market prices can be mitigated by margin calls and offset using netting agreements and collateral. In most cases credit risk mitigation is in the form of either cash collateral or bank guarantees. Firms can build in the right to ask for a letter of credit. Where firms have control over the documents required for letters of credit, compliance can be ensured with low discrepancy.

Firms were keen to point out that money has not been lent as in banking, with the expectation of earning a higher return for the credit risk taken. Credit risk was an exposure incidental to transactions that is mitigated where possible.

Credit risk management, like market risk management, is well established in the trading operations. All firms have credit management policies requiring approval of counterparties, setting of counterparty limits and monitoring exposures against limits.

In cases where firms wish to deal with counterparties without established limits, or where limits are approached, they may require pre-payment or bank guarantees or collateral.

In all cases, the methodology for limit setting is documented and limits are reassessed regularly. These limits tend to be set by either the Credit Risk Committee or by the credit risk management team. However, less than half determine the credit risk appetite according to the available capital.

All firms have defined processes for dealing with limit breaches.

All firms use recognised credit ratings, where available, to rate the credit risk of their counterparties. However, in many cases external ratings are not available.

Two types of exposure are typically assessed, settlement and pre-settlement. Settlement dates can vary considerably from days to over a month after delivery. Only one firm uses cVaR methodology to measure credit risk. Most firms consider concentration risk.

One company mentioned that it would be willing to self-impose cash collateral requirements to avoid holding capital.

10. OPERATIONAL RISK

Operational risk is the category with the widest diversity in terms of sophistication of practices and management effort. With the exceptions of two respondents, operational risk is defined as a distinct risk category (with many companies including legal risk within the operational risk

category). However just two-thirds of respondents have a specific policy for operational risk which outlines its approach to identifying, assessing, monitoring and mitigating the risk.

Identifying and assessing

The survey indicated that most respondents identify and record all material risks associated with both existing and new products, activities, processes and systems. The majority assess the likelihood and impact using self-assessments.

The types of operational risks include deal entry errors and other such breakdowns in trading processes, such as failings in collateral documentation. Operational risks related to the physical production or delivery of commodities are not considered part of trading.

Controlling and mitigating

Only two-thirds of the respondents actually assign accountabilities for managing operational risk.

Less than half of the respondents ensure that remuneration to staff does not provide incentives to operate outside of risk appetite. This kind of measure can limit the risk that other risk management controls, such as limits, are breached.

All but one firm has business continuity and disaster recovery plans in place for the commodity operations, most tested annually.

Specific controls over trading activities

The most common trading specific control were largely in place, such as:

- Segregation of duties between roles to avoid conflicts of interest (all respondents);
- Systems controls to ensure traders can only trade under their own ID;
- Logs of traders entries that they cannot access or amended (all but one respondent);
- Recordings of front office conversation (all but one respondent); and
- Front office / back office reconciliations (all but one respondent)

In most cases, firms have procedures to establish that transactions comply with market requirements, and for approval of any non-standard features.

Monitoring

Half of the respondents stated that they used key risk indicators (KRIs) to monitor changes to operational risk, with targets and tolerances in place in order to trigger actions.

Nearly half claim to be monitoring the operational risk profile monthly, yet most of the others are reviewing it less than quarterly. Internal audit generally periodically reviews the adequacy of controls.

Losses or incidents are routinely identified, investigated and reported in most firms, and defective controls are remedied. More than half of the firms systematically record details of operational incidents, though they do not typically use such data for any kind of operational risk capital assessment.

Only half the respondents submit regular reports to senior management and the board on the operational risk profile of the trading operations. Where they do, these cover the risk profile, problem areas and incidents at a minimum.

11. **LIQUIDITY**

With two exceptions the respondents stated that they have a strategy to measure and monitor liquidity risk for the entity (as opposed to separate for commodity trading area). Just over half of the respondents indicated that they prepare scenario analysis over an appropriate timeframe of likely inflows and outflows. In some cases, this analysis includes assessing the impact of a rating downgrade of the firm and the increase in demand for collateral from counterparties.

12. **INTERNAL AUDIT**

All but one of the respondents has an independent Internal Audit function which reviews the activities, processes and models within the commodity trading operations. Generally, this audit function is part of the larger group. In two-thirds of cases a risk-based approach is used to plan the frequency and scope of audits.

Reports of the findings are provided to management. Internal audit are in most cases responsible for monitoring resolution of the issues identified, with management being responsible (or jointly so) in some firms. With two exceptions, outstanding audit issues are reported to Senior Management and the Board.

Most respondents stated that an audit had taken place within the last 6-12 months.

13. **DISCLOSURE**

Less than half of the respondents to the survey said they disclose anything about their risk management. A few disclose the governance framework, approach to risk identification, assessment, controls and monitoring. Two disclose market risk and credit risk exposures in addition. The interviews revealed that a number of firms have disclosures about their risk management frameworks in their annual reports, but these are generally at the group level, and do not isolate the trading activities.

14. **CONCLUSION**

A number of firms communicated their view that one of the purposes of banking prudential regulation was to protect the interests of retail customers and limit systemic risk to the payments system. These commodities traders only deal with trade counterparties and non-retail customers like industrial firms. Such counterparties and customers have the capabilities to assess the risks of the trades they enter into. The failure of any counterparty may have limited flow on effects to other parties. For example, the collapse of Enron had limited impact on the market. In addition, there are other ways of managing risk than holding capital.

The nature of the trading activities, products and structure of the organisations surveyed differs considerably. The majority of respondents nevertheless have relatively sound methodologies for measuring and managing market risk within defined limits.

Firms rely heavily on forms of credit risk mitigation such as margining agreements, netting agreements and collateral, and generally have sound processes for limiting and monitoring credit risk. There is considerable variation in the degree of sophistication in operational risk management. Also, many firms do not have an integrated view across all risk classes. For example, stress testing focuses mostly on market risk and does not always consider a combination of events from all risk classes.

The proposed standards for risk management and disclosure are likely to require a greater degree of formalisation of operational risk management practices and better analysis of the interaction of risks and assessment of the aggregate risk exposure relative to the available financial resources.